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Local public sector in transition: A Nordic perspective

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Preface and acknowledgement

This book is intended to serve as a resource for those who want to understand the recent reforms of local government organisation, tasks and funding in Finland, Denmark, Norway and Sweden. A special focus of the book is on Finnish local government and how the present Finnish situation compares with developments in other countries. However, this book also offers a more general view of local government reforms and in the way that fiscal federalism has been affected by the global fiscal crisis.

The articles in this book are written by researchers who are all acknowledged academic experts in local public finance and local governance. As editor I want to express my sincere appreciation and thanks to all the authors for writing these original essays. I also want to thank my employer, The Finnish Government Institute for Economic Research, for the excellent support and encouragement received in all stages of this project, paying special thanks to the Institute's Director General Seija Ilmakunnas and Research Professor Aki Kangasharju. I would also like to express my special gratitude to the Finnish Prime Minister's Office which has co-funded this project, especially to the Office's Economist Pekka Sinko and State Under-Secretary Jukka Pekkarinen who have commented on the book at different stages. The Finnish Prime Minister's Office also arranged an external commentator for the book, Professor Hannu Tervo from the University of Jyväskylä, to whom I also want to express my gratitude. I thank Mr Howard Kitson for the English proof reading of parts of this book. Finally, I am deeply grateful to Research Assistant Henri Lassander who has assisted greatly by preparing the layout of the book and whose help in different stages of this project has been invaluable.

Helsinki, 8.10.2010

Antti Moisio

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Chapter 1

Introduction

Antti Moisio

In international comparisons and political debate the Nordic countries are often described as a region that successfully combines equality and economic success. As a result, the expressions “Nordic model” and “Nordic welfare state” have become common terms to describe political and social systems that aspire to high levels of fairness. Less well known is that all Nordic countries rely heavily on local governments for their public service provision, and that they are among the most decentralised countries in the world. The local governments in Denmark, Finland, Sweden and Norway have a crucial role in providing and delivering the health, education and social services. Also the tax raising powers of the Nordic local governments are high when compared internationally. But despite the many similarities between the Nordic countries, a closer examination reveals some important differences in local government structure, financing and tasks. Each country has chosen its own way to practice the welfare state and the way that the sub-national level of government is involved in welfare service provision.

The fact that the basic fiscal framework is similar but that the practical implementation differs, gives an interesting opportunity to compare these four countries and to analyse the effects of the different policies at the local government level. It also seems that all Nordic countries face similar future challenges, especially in the light of population ageing, public finance sustainability and globalisation. Learning from other countries’ experience should be easy in a situation where the basic structures of local government are so similar. In the Finnish case, the comparisons with the other Nordic countries are especially interesting. This is because Finland is at the outset of structural reforms that have already been implemented in Sweden and Denmark and to a degree in Norway.

This book consists of six essays of which four discuss and analyse the situation of the local governments in Denmark, Finland, Sweden and Norway. In addition, two essays provide a more general view of fiscal federalism. Each author was also asked to briefly comment on the Finnish situation. In order to be able to do this, the authors were sent a recent report that describes Finnish local government (Moisio, Loikkanen, Oulasvirta 2010). These comments are collected together in the last chapter of the book.

The rest of this introduction provides a short summary of each essay trying to identify the key points for busy readers. Chapter two addresses the key policy issues associated with managing fiscal relations across levels of government. Chapter three consists of three sub-chapters, each describing local government in one Nordic country. Chapter four describes the Finnish local government. Chapter five discusses the ways to reform the local government to prepare it for future challenges. Finally, chapter six presents expert comments and suggestions for Finnish local government.

1.1 Fiscal federalism in the aftermath of the global fiscal crisis

The first paper of the book, by Camila Vammalle and Claire Charbit, starts with a thorough presentation of the traditional principles of fiscal federalism, and how these principles have evolved during the last decades in the OECD countries. They note that there is a wide array of multi-level government systems in the OECD, and that these systems involve a more complex assignment of tasks than the classic assignment of expenditure and revenue functions of Musgrave and Oates. In addition, they find that the present global fiscal crisis has affected adversely the implementation of fiscal federalism in OECD countries. As a result, they argue, the importance of policy coordination and partnership between central and local levels has greatly increased. Also, the traditional principles of fiscal federalism that are based on issues such as separation of central and local government, minimum interactions between different levels of government and competition between sub-central governments, may no longer apply. Interestingly, Vammalle and Charbit show that the countries that had existing institutions for inter-governmental coordination, were in the best position to respond to the recent global fiscal crisis. They emphasise that the future challenge among the OECD countries is to reform the central-local relationships to get them to work better together. This is not an easy task, however, as the tensions between central and local level may actually be increasing in the aftermath of the crisis, as someone will need to bear the cost of the consolidation. While the available policy tools (fiscal rules, taxes and grants) are the same as before, something totally new may be needed to avoid a “war of attrition” between levels of government. Although the financial crisis may have highlighted the need for reform, it may also make structural reforms more difficult, as there is less money to compensate losers.

1.2 The Nordic experience

Denmark

The article by *Jens Blom-Hansen* provides an in-depth discussion and analysis of the Danish local government. According to Blom-Hansen, the Danish state-local relationship is characterised by the strong position of central government. A good example of this was the big reform in 2007, when the number of municipalities was reduced from 271 to 98 and the 15 counties were replaced by five regions.

The major tasks of the Danish municipalities consist of social services, primary schools and employment services. The regions concentrate solely on health care services. Municipal financing is based mainly on a local income tax. Municipalities are free to set their income tax rate, although municipal taxation is constrained by the yearly agreements by the central government and the municipal sector. Municipalities also levy taxes on property and receive a share of corporate income taxes, but these taxes generate far less revenue. The second most important revenue source is grants from the central government that are mainly in the form of block grants or general grants. Municipalities also get revenues from user fees.

The regions are financed solely by municipalities and central government grants. Most of the funding for the regions is provided by central government block grants that take account of both a region's needs and performance. The grants from municipalities to regions are of less importance. The main purpose of the municipal grants to the regions is to make the municipalities jointly responsible with the regions for health expenditure. The aim is that this will provide an incentive for the municipalities to establish effective health promotion and disease prevention measures within their health care areas.

The Danish system of annual negotiations between the central government and the association of local authorities results in an agreement of the overall spending and revenue levels in the local governments. This system has been in place for decades and in the past, the system was able to keep the municipal expenditures within the agreed limits. But since 2007 the negotiation system has been less successful, as in 2008 the municipal expenditures grew much faster than agreed. To constrain the municipal expenditure growth, the central government has tightened the economic control by sanctioning the municipalities that have failed to follow the agreement.

According to Blom-Hansen, the Danish system has been successful especially if judged by macroeconomic control of the local government. However, Blom-Hansen also points out three areas of concern. First, the coordination between the municipal and regional level operation has proved to be a challenging task.

Although the Danish regions are now in practice single-purpose entities, the regional tasks still partly overlap with the municipal tasks. Second, the future of the regions seems uncertain. As the 2007 reform stripped off most of the powers from the intermediate level, political participation in the intermediate level has become less interesting. The debate about the proper organisation of the regional level is not over in Denmark, and there is speculation about abolishing the regions and establishing hospitals as independent organisations controlled by user boards. The third big challenge arises from the need to control municipal and regional expenditure. As mentioned above, the central government has been forced to use strong measures: if the municipalities raise taxes above the agreed guidelines, the general block grant is reduced by the same amount. These measures have guaranteed a perfect obedience from the municipal side, but in return no municipality dares to lower their tax rates. As some municipalities face rising costs, for instance due to local demographic developments, they can react by either pressurising the central government for more grants or by cutting local welfare. Blom-Hansen doubts that this state of affairs is sustainable in the longer run.

Norway

The third article of the book, written by *Lars-Erik Borge*, describes and analyses Norwegian local government. In Norway, local government consists of 19 counties and 430 municipalities. The number of municipalities and counties has been quite stable during the past decades, and some of the municipalities have very small populations. Instead of big mergers, the most important recent reform in Norway concerning local government has been the health care reform in 2002, that transferred the responsibility of hospitals from the counties to central government.

In Norway, the most important tasks for municipalities are social services and primary and lower secondary schooling. The counties concentrate on upper secondary education (general and vocational) but they also provide transportation services and are in charge of regional planning. In terms of revenues, the municipal level is more than 5 times as large as the county level.

Income tax is by far the most important revenue source for both the municipalities and counties. Central government grants and user fees are the second and third most important revenue sources for both government levels. The counties are more dependent on central government grants, while user charges are more important for the municipalities. Municipalities also have the right to use property taxes and they get a fixed share of the wealth tax revenue and of the natural resource tax revenue. The most prosperous municipalities are the small rural communities with waterfalls, where property tax and natural resource tax from power companies make up substantial amounts per capita.

Norwegian local governments do not have much tax autonomy. Although municipalities have the right to set tax rates within limits set by central government, these powers are not used by the municipalities. Instead, the municipalities have used the maximum tax rates in income and wealth taxation during the last 30 years. Hence, this tax discretion applies only to the municipal property tax. The county governments have even less tax discretion since they do not have property tax. Borge argues that local tax autonomy should be increased, because greater tax discretion would result in more efficient and equal provision of local public services. Borge also sees that local tax discretion would improve local democracy by increased voter participation in local elections.

A major challenge for Norwegian local government is that, despite the substantial equalisation system, the differences in fiscal capacity are large. The regional policy grants and natural resource tax revenues result in large differences in service provision and cost efficiency between municipalities. According to Borge, the Norwegian regional policy should be re-designed with less emphasis on grants to local governments.

The situation of the counties poses another challenge for the Norwegian decision-makers. According to Borge, there are two alternatives: first, to enlarge the counties and their responsibilities or, second, to abolish the intermediate government level completely. The latter option may not be feasible because most of the municipalities are too small to take responsibility for all of the county level tasks. Borge concludes that in the short term, there is still a need for the middle tier, but with a down-scaled administration and political system (possibly with council members appointed by the municipalities).

Despite many efforts to reduce the number of municipalities by merger reforms, municipal mergers have not been common in Norway. According to Borge, the slow process of increasing the population size of the municipalities is a challenge for the efficiency and quality of service provision, as the welfare services are getting more complicated and require more skills. Small municipalities have problems in recruiting competent personnel to satisfy national regulations and to meet demands from citizens. If the present policy of voluntary mergers continues, it seems likely that in the longer term the central government will take on more responsibilities for provision of welfare services. As for municipal cooperation, Borge does not see that this could be a serious alternative to merger reform in Norway. 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.

Sweden

The last article of section three is by Matz Dahlberg, who analyses the Swedish local government. In Sweden, there are presently 290 municipalities and 21 counties that together form the local government sector. Of the two local government levels, the municipalities are responsible for more tasks and handle a much larger budget. The main municipal tasks are the schooling, elderly care, child care and social care services. The counties are mainly responsible for healthcare services.

In Sweden, the local income tax is the only tax revenue available to municipalities and counties, and it generates the biggest share of the municipal and county revenues. Inter-governmental grants and user fees form the second and third biggest source of funding. Both the municipalities and the counties can set their income tax rates. They can also decide on spending levels and are allowed to borrow freely on both domestic and international credit markets. The grant system for the municipalities and counties is mainly based on revenue equalisation but also on the service needs and cost differentials as well as structural differences which are taken into account.

In his article, Dahlberg discusses carefully the most important Swedish reforms concerning local government. For the amalgamation reforms (these were mostly done between 1952 and 1974) Dahlberg takes up the common pool problem. The common pool problem exists when a municipality has an incentive to raise its per capita debt before the amalgamation. The empirical evidence from the Swedish amalgamation reforms supports the common pool problem. Therefore the policy recommendation is that the reforms decided by the central government should follow strict protocols to prevent this malpractice. The common pool problem may also prevent otherwise reasonable voluntary amalgamations, if no previously agreed debt policy exists.

As an example of reforms of municipal tasks, Dahlberg discusses the decentralisation of primary education in the 1990s. Before 1991, the primary schooling system comprised central government regulations, centrally employed teachers and earmarked grants for specific categories of school spending. After the reforms, the municipalities were funded with a general grant that allowed the municipalities to allocate freely their money across different tasks. In addition, wage settlement for teachers was devolved to school level. Since the implementation of the education reforms, Sweden has experienced an overall decline in education expenditures relative to GDP and a decrease in the number of teachers in compulsory schools. Moreover, school resources have decreased most amongst those schools with students that were already provided with low resources. As a result, student performance has clearly lowered in Sweden. Based on this evidence, Dahlberg concludes that decentralisation might lead to an undesirably large variation in school resources. Hence, from an equity perspective, a decentralised school system might not be desirable, and some centralisation of resources for schooling might be necessary.

As for the municipal revenues, Dahlberg thinks that due to business cycle swings, the Swedish local tax revenues are far too volatile. This poses a threat to the provision of important welfare services such as education, child care and elderly care. The situation could be improved by tying grants to the general macro economy swings or by centralising some of the municipal services. Alternatively, the requirement for municipalities to have balanced budgets could be relaxed so that municipalities could build up funds in good times to be used in bad times. Dahlberg also suggests that the Swedish tradition of using discretionary grants to fund municipalities should be abolished in order to avoid the soft budget constraint problems.

1.3 The Finnish local government

In the fourth section of the book, Finnish local government is described and discussed by Antti Moisio, Heikki A. Loikkanen and Lasse Oulasvirta. In Finland, unlike in the other Nordic countries described in this book, there is only a single tier of local government. In 2010 there are 326 municipalities and 226 joint authorities formed by municipalities that are in charge of all education, health and social services. In addition, municipalities provide local infrastructure, housing and planning services. In practice, municipal cooperation has replaced the intermediate government tier and has made it possible for the small municipalities to exist.

The Finnish municipal finances consist of tax revenues, grants, user fees and sales revenues. The main source of municipal revenue is the municipal income tax. There is also a municipal property tax, but its importance is small. In addition, municipalities receive a share of state corporate tax revenue. Municipalities are free to set their income tax rates without limits and they can set their property tax rates within the limits set by central government. Municipalities do not have rights to affect the tax bases (tax reliefs or deductions). Municipalities decide autonomously on spending levels and they are allowed to borrow freely. There is a single block grant that is based mainly on cost equalisation formulae. The system also takes account of revenue equalisation. Like other Nordic countries, the grant system results in a high degree of equalisation between municipalities.

The most important reform in the Finnish municipal sector to date was the grant reform in 1993. This reform, that was refined in 1997, caused a fundamental shift from a pure matching grants system to a block grants system. The grant reform and the accompanying Local Government Act reform in 1995 gave municipalities more freedom to decide upon their own matters. As a result, the productivity of municipal services improved considerably at the end of the 1990s, although the deep economic recession and the central government tight fiscal policy in the beginning of the decade had an effect too.

At present, the major municipal reform is the ongoing PARAS reform that aims to achieve economies of scale and sufficient capacity in the municipalities to provide services. In practice, the PARAS reform encourages municipalities to merge or to increase co-operation. The resulting larger catchment areas are expected to help the municipalities to cope with the increasing costs of local public service provision due to population ageing and internal migration. So far, the PARAS reform has been successful in creating larger catchment areas, but the effect on the actual municipal services is still to be seen. In fact, the reforming of the service structure after reaching the required minimum population bases – by merger or cooperation – has been left to the municipalities themselves. But past mergers do not have a convincing record in cost savings or efficiency improvements. Therefore, it is unlikely that the present mergers will have immediate beneficial effects on either service improvements or cost savings. The OECD has criticized the PARAS reform for a lack of strategic vision and complexity that can seriously jeopardize success in the ultimate goal of reforming the service structures.

Another interesting effort to reform the local public sector in Finland is the administrative experiment in Kainuu region. An experimental regional level authority for cooperation and decision-making was launched in the Kainuu region in 2005 and the experiment is to last until 2012. This regional level authority is in charge of 60 percent of all municipal tasks in Kainuu region, including health care, social services (except daycare), secondary schooling and planning. Kainuu regional authority is governed by an elected council. The financing of the Kainuu regional authority comes from the nine member municipalities so that each municipality pays 60.1 per cent of their revenue (tax revenue and grants) to the regional authority. The Kainuu regional authority differs from the traditional Finnish joint authorities mainly with its elected council, with its extensive list of tasks and its fixed budget financing. The latest evaluation reports claim that the Kainuu experiment has been successful in cutting costs and improving efficiency. On the other hand the Finnish National Audit Office has offered a much more critical view of the achievements of the Kainuu experiment. In sum, there is clearly a need for more empirical evidence on the effects of the experiment, before any conclusions about the suitability of the model for wider use can be made.

In the conclusion of their paper, Moisio, Loikkanen and Oulasvirta discuss the present challenges to the Finnish municipal sector. First, the benefits of the intermediate level should be further explored for example by extending the

Kainuu experiment or by setting up an intermediate level of governments in the surroundings of the main urban centres to take care of tasks like land use and transportation. Another alternative could be to intensify the PARAS reform by amalgamations of the weakest municipalities into neighbouring towns or cities – voluntarily or by force – to create stronger independent municipalities. With more equal partners for cooperation, the inter-municipal cooperation could then concentrate on services that truly need a larger scale of operation. That said, it may well be that the traditional methods or thinking may no longer apply in solving the future problems of local government. It is equally possible that the answers can be found from better utilisation of market mechanisms in the municipal sector. Indeed, this development has already started as a growing number of municipalities are presently outsourcing their services and utilising vouchers in the service provision.

1.4 Reflections on the Reform of Local Governance for the Next Decade

The essay written by *Anwar Shah* begins with discussion of the change that has taken place during the last decades: the globalisation, the market liberation and the information revolution. Shah argues that despite these positive developments, the global financial crisis has recently forced us to reconsider the role and responsibilities of local governments. In his essay, Shah discusses the future of local government from several perspectives: traditional fiscal federalism, new public management, public choice, new institutional economics, and network forms of local governance. As a synthesis, Shah argues that top-down hierarchical controls are ineffective, as they tend to disregard client orientation, bottom-up accountability and lowering of transaction costs for citizens. According to Shah, local governments can have a major role in the new public governance provided that the central control over them is diminished. In the future, local government should operate actively as purchaser of local services and as a facilitator of networks of government providers and entities beyond government. According to Shah, the funding of local government should be based on output based grants rather than on complicated formula based block grants.

1.5 The Finnish model – which way forward?

Camila Vammalle and Claire Charbit base their comments on several recent OECD reports on public governance, regional policy and policy reforms. First, they emphasise the need for reform in Finland due to the socio-economic forces (population ageing, internal migration) and the recent global fiscal crisis that together seriously challenge the viability of the present organisation of the local government. They note that other Nordic countries and many EU countries have recently gone through structural reforms to increase the municipal size and to reinforce the regional government. They also note that in some cases, like in Sweden, the regional structure has not been based on a single “one size fits all” model. This process of “asymmetric decentralisation” enables the learning-by-doing and tailoring different solutions for regions with different needs and capacities. But with this development there is also a risk of creating a complex and heterogeneous system in which accountability mechanisms are unclear and the credibility of the regional level is limited. But based on the recent OECD reports on Finland, Vammalle and Charbit argue that in practice Finland has already allowed a rather asymmetrical decentralisation. Another point they make is that while the PARAS reform has already been able to increase the municipal size, it seems that the municipalities do not yet have strong enough incentives to seek structural changes. This situation could be improved by altering the equalisation mechanisms so that the small municipalities have a clear incentive to improve their cost efficiency by merging or joining a cooperation area. The PARAS reform would also benefit from setting clear targets for the mergers and clear guidelines for the cooperation areas. In addition, there is clearly a lack of good quality information on the effects of different experiments and of the PARAS reform. Based on the OECD experience of the successful reforms in the member countries, Vammalle and Charbit recommend bundling several reforms together. This could push public administration reforms through, as stakeholders may lose from some elements of the reform while benefiting from others, therefore being either indifferent or even supportive of the reform as a whole.

Jens Blom-Hansen comments on the Finnish system using the Danish experience on municipal amalgamations, equalisation schemes, macroeconomic control and intermediate government level. Based on the experience of a massive scale amalgamation reform performed in Denmark in 2007, Blom-Hansen sees the biggest challenge as controlling municipal expenditure. Municipal expenditure may easily increase because of common pool problems, pressures to improve the municipal service quality or because of failure to utilise economies of scale. To fight the common pool problems, Blom-Hansen emphasises the importance of clear rules in advance of the amalgamations. This could mean, for example, restrictions on local investments, current spending levels and tax rates. Also, compulsory saving schemes in advance of the mergers could help to avoid the “spend before closing time” behaviour.

To constrain the municipal expenditure growth after the merger can be difficult too, because of political pressure to show positive effects of the mergers and because prior to the mergers, local citizens are usually told that amalgamations will result in local service improvements. In addition, the latest research results from Denmark show that it is very difficult to gain economies of scale effects from the amalgamations. This is not to say that amalgamations do not have any positive effects. Mergers force the municipalities to reconsider their organisation, service standards, administrative routines and number and size of their services units. But the lesson from the Danish experience is that in economic terms municipal amalgamations carry considerable risks and no easy gains.

As for the equalisation systems, Blom-Hansen shows that the problems discussed in Finland are topical issues also in Denmark. The block grant systems that are based on measures of need and cost factors usually suffer from the difficulty of finding a balance between fairness and transparency. In addition, grant system reforms are often difficult to manage because they need to be implemented as zero-sum games between municipalities, and this causes political problems. It is then likely that the status quo of grant policies will be constantly challenged.

In Denmark the local governments are subjected to tight macroeconomic control. This situation is based on the system of annual economic negotiations between the central government and the association of local and regional authorities. As a result of these negotiations, an agreement that defines the overall expenditure and revenue of the local government sector is signed. Although individual municipalities may deviate from the agreement, in practice the system is rigid because municipalities cannot adjust their own revenues due to fear of central government sanctions. According to Blom-Hansen, the Danish structural reform has contributed to increased local government expenditure and to keep the expenditure of the local governments within limits, the central government has implemented tight control measures, which in turn have decreased the autonomy of the local government. A reform that will create considerably bigger municipalities will perhaps need an accompanying reform of fiscal rules to control the growth of public expenditure.

Lastly, Blom-Hansen shows that in Denmark the status of the regional level of government has traditionally been weak because of lack of support from the citizens. Therefore, in Denmark, the argument for regional government service provision is not local democracy but instead the administrative efficiency. All in all, the Danish model seems to be based on strong municipalities and not so much on regionalisation. Blom-Hansen ends by stating that based on the Danish experience, he cannot recommend any large-scale regionalization efforts in Finland unless a strong regional allegiance by the local citizenry can be demonstrated.

Matz Dahlberg comments on the Finnish system of joint authorities, the municipal amalgamations, the grant system and the tasks of municipalities. Dahlberg sees several potential problems with the joint authorities. For example, it might be difficult to secure adequate preference matching and transparency and accountability of decision-making, when the decision-makers of the joint authorities are not elected but instead nominated by municipalities. The joint authorities may also create common pool problems in cases where the cost of joint authority membership to municipalities is fixed (as in fact is the case in the Kainuu regional authority experiment). According to Dahlberg, one solution to these problems is to impose an additional local government level which would be responsible for services that need a large population base and whose decision-makers are elected in general elections. As for the specific question of the correct level of government to perform the planning of land use, Dahlberg emphasizes that without good information on the benefits and costs of larger jurisdictions, it is hard to say what the optimal jurisdictional size should be for land use planning.

Dahlberg thinks that there is room for policy improvements concerning the municipal amalgamations in Finland. While the research results have not been able to show that amalgamations will result in significant economic improvements, it should be noted that the existing research can show that local democracy will suffer with larger municipalities. Moreover, the Finnish policy of voluntary mergers supported by extra grants to merging municipalities might reward inefficient, debt-financed, spending behaviour. Instead of the voluntary approach to amalgamations, the process could be improved by a central government led programme whereby the central government announces the amalgamations that should happen and follows the process through until the amalgamations have taken place.

At present, in Finland a large share of the grants allocated to the municipalities is based on municipal characteristics. According to Dahlberg, this is problematic because the municipalities may be able to affect some of the variables through their policies, and thereby the allocation of grants. The weights used for the different municipal characteristics in the allocation rule seem also problematic.

As for the large variety of municipal tasks in Finland, Dahlberg points to the research on decentralisation of schools and welfare assistance in Sweden, which indicates that decentralisation might lead to an undesirably large variation in school resources for students from the society's point of view. Therefore, some centralisation of the municipal tasks should be considered.

Lars-Erik Borge comments on the Finnish municipal structure, cooperation among municipalities, the discussion about middle tier of government and the equalisation system. The Finnish municipal structure much resembles the Norwegian one, with a high proportion of small municipalities and a voluntary programme of amalgamations to reform the municipal structure. But the Finnish PARAS reform seems to have been successful in reducing the number of municipalities whereas in Norway amalgamations have been rare. Therefore, although Borge supports the idea of a national solution to create a new municipal structure in Norway, the situation in Finland seems to make him wonder. In Finland, those municipalities who decide not to merge, choose to cooperate. In Norway, this is not the case. So it seems that the Finnish case with extensive cooperation is special and may need another kind of solution. Nevertheless, the Finnish system of joint authorities seems to be somewhat problematic as it can result in unclear responsibilities and little accountability.

As for the middle tier of government, the present Norwegian and Finnish discussion are concentrated on the same issue, but from opposite points of view: in Norway the abolition of the intermediate tier is on the agenda. According to Borge, the Norwegian experience is that it is difficult to build up sufficient political legitimacy for a new middle tier. Since its establishment in Norway in 1976, the middle tier has never been able to fulfil its expectations. The citizens are far more attached to municipal and national politicians than to county politicians. Therefore, Borge does not recommend that Finland to establishes an intermediate government tier with its own taxation rights and an elected council for small purpose services like regional planning, transportation, and other minor issues. If such an intermediate level were to be established, the responsibility for something very important like the hospitals should be a pre-condition.

As for the equalisation system, Borge has three proposals. First, the separate block grants formulas for education, health and social services should be combined into a single block grant. This would make the system less confusing. In addition, the cost equalisation could be made self-financing by letting contributions from municipalities with below average calculatory costs finance the transfers to municipalities with above average calculatory costs. The central government funded amount of money in the present cost equalisation grants could be transferred into a flat per capita grant. Lastly, the system could be improved by altering the revenue equalisation so that the municipalities below the 92 per cent threshold would receive less than 100 per cent compensation. This would improve the incentives to develop the local tax base.

Anwar Shah comments on the Finnish case mostly from the governance point of view. When compared to many other industrialised countries Finland seems a success story rather than a problematic case. Shah thinks that the Finnish solution with wide municipal tasks actually recognises the role of municipalities as primary agents of people and is therefore a positive thing from the local democratic point of view. The local government structure in Finland without an intermediate level and with extensive municipal cooperation is also a positive element that should not be reformed. For financing of local governments, Shah recommends the use of output-based fiscal transfers for merit goods that set national minimum standards in education, health, social welfare and infrastructure. The mistake of basing the equalisation systems on complicated formulae as done in Australia, Netherlands and several other countries should be avoided. The Finnish municipalities should aim to achieve performance budgeting by linking their budgeting with planning, evaluation and human resource management. Overall, Shah thinks that the Finnish model can be improved with fine tuning rather than comprehensive reforms.

Chapter 2

Fiscal Federalism. Recent Developments and Future Trends[1]

Camila Vammalle – Claire Charbit[2]

2.1 Introduction

By highlighting mutual dependency and the need for coordination between levels of government, the global financial crisis has shaken the traditional principles of fiscal federalism. Indeed, traditionally, fiscal federalism rests on the principles of "separation" (strict separation of competencies defined by the Constitution or the law), "non-interference" (minimisation of interactions between different levels of government) and "competition" (both between sub-central governments, but also vertical competition between levels of government). But these last decades have seen a general trend in OECD countries towards greater delegation of spending responsibilities to sub-national levels of government, while at the same time, macroeconomic pressure on central governments (CGs) has increased. Sub-central governments (SCGs) thus face increased responsibilities in terms of public service delivery, but do not always have the discretion about the level of their resources, nor about how to spend these. This leads to a situation of mutual dependency between levels of government, where CGs need the cooperation of SCGs in order to achieve their nationwide macroeconomic objectives, while SCGs need to negotiate the allocation of resources, spending responsibilities and expected results with CGs. In particular, to tackle the global financial crisis and

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[1] This article is based on work carried out for the OECD Network on Fiscal Relations across Levels of Government. The authors would like to thank Lee Mizell, Hansjörg Blöchliger and Timothy Goodspeed for their contribution to this network. For more information on this network, please visit: http://www.oecd.org/ctp/federalism

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implement timely and effective stimulus programs, CGs soon realised that SCGs were unavoidable partners, for at least two reasons:

1. SCGs were also facing financial difficulties due to the crisis (declining revenues and raising expenditures, especially for those SCGs with large responsibilities in terms of social protection). They could therefore be tempted – or obliged – to cut expenditure (in particular investment) and raise taxes, which would have contributed to worsening the real sector and social crisis;

2. On average, SCGs are responsible for two thirds of public investment in OECD countries, and have the information about the desirability and feasibility of investment projects which could be implemented very fast ("shovel ready" projects as they were called in Canada). They were therefore a necessary partner for implementing the stimulus packages, as these heavily relied on public investment.

The global financial crisis thus clearly highlighted the mutual dependence between levels of government, and therefore, the need to coordinate their responses to the crisis. Indeed, CGs stimulus plans were deemed to fail if SCGs carried out pro-cyclical ("anti-stimulus") policies, but SCGs would not have had a choice than cutting expenditure – thus investment – without CGs actions (either by providing direct financial support, by relaxing budget rules to allow SCGs to exceptionally increase budget deficits, by facilitating SCGs' borrowing, etc.).[3] Besides, in the advent of a slow recovery and long lasting high unemployment, more and more people will move from unemployment benefits to social welfare programs. As in OECD countries, SCGs often have large responsibilities in terms of welfare, this could therefore cause a lagged and long-term impact of the global financial crisis on SCG finances. The need for coordination across levels of government is therefore both immediate, and potentially long lasting.

Those countries who already had a tradition of coordination between levels of government and who counted with the appropriate institutions for this coordination saved time in implementing their recovery strategies (such as Australia with the COAG or Canada with the Regional Development Agencies). Other countries had to create these institutions (ex. Sweden extended the experimental project of the "Regional Coordinator"), or suffered from their absence (as the United States). Ironically, highly centralised countries (such as Korea) did not face such coordination problems, as all decisions could be taken

[3] For an analysis of the early reactions of central and sub-central governments to the crisis, please see Blöchliger, Charbit, Pinero-Campos, Vammalle (2010), Sub-Central Governments and the Economic Crisis: Impact and Policy Responses, Economics Department Working Papers No. 752, OECD, Paris.

by the CG (but if this allowed them to act fast, it may not have led them to choose the potentially most relevant investment for long term development).

The design of intergovernmental fiscal relations bears multiple – possibly conflicting – objectives: macroeconomic stability, efficiency of spending and redistribution concerns. The main instruments to achieve these goals are fiscal rules, taxes and grants. This paper addresses some of the key policy issues associated with managing fiscal relations across levels of government. The next section presents the key issues associated with managing fiscal relations across levels of government. Sections three to six analyze how the key instruments such as expenditure assignment, revenue assignment rules and performance indicators are used in order to achieve the efficiency, equity and stability objectives. Section six gives some preliminary findings of a study carried out by the OECD Network on Fiscal Relations across Levels of Government on the political economy of fiscal decentralization reforms, and presents a preliminary summary of recent and planned reforms in a sample of OECD unitary countries. The final section concludes.

2.2 Objectives of intergovernmental fiscal relations

There is a clear trend in the last decade towards a greater devolution of spending and revenue raising capacities to SCGs, following the idea that decentralisation of spending responsibilities can improve efficiency in the allocation of resources and welfare. Indeed, local governments should have better information about local needs and preferences, and could therefore provide a composition, quantity and quality of public goods closer to the preferences of their beneficiaries[4]. But decentralisation has also its drawbacks, aggravating regional differences and undermining distributional equity. As stated above, the global financial crisis has shown that decentralisation makes macroeconomic management more delicate, as SCGs actions can go against central government's macroeconomic objectives[5] and coordination between levels of government becomes necessary.

To achieve its three objectives (efficiency, equity and stability), the design of fiscal relations across levels of government has three main policy tools: the share, composition and autonomy of SCGs expenditures, the share, composition and autonomy of SCGs revenues, and fiscal rules.

Allocation efficiency concerns are mainly addressed in the assignment of spending responsibilities. The general rule is that to increase efficiency in the

[4] See for instance Tiebout (1961), Musgrave (1969), Oates (1972) or Ter-Minassian (1997).

[5] See Prud'Homme (1995) and Tanzi (1996).

allocation of resources, the responsibility for each type of public expenditure should be assigned to the level of government that most closely represents the beneficiaries of these services. Therefore, in general terms, the more spending autonomy is given to SCGs, the greater the allocation efficiency. But the efficiency benefits from spending delegation must be balanced with possible negative impacts of spending decentralisation on other objectives, such as equity (as poorer regions will not be able to provide the same level of public goods than more developed regions) and macroeconomic stability (as the addition of all SCGs spending might lead to over-spending on a global level). Besides, as some locally provided public goods and services might have externalities which will not be taken into account by SCGs, the aggregate level of public goods provided might not be optimal. An example of such goods is education or basic health care, which affect the overall stock of human capital, and therefore the potential for growth at national level.

Equity (income redistribution) concerns are one of the key elements in the allocation of revenues. The main sources of financing for SCGs are own taxes, and inter-governmental transfers (tax-sharing and grants). The larger the reliance of SCGs on own taxes, the larger the potential discrepancies between poorer and richer regions. Inter-governmental transfers are thus needed to increase distributional equalisation. These can take the form of tax-sharing, where the coefficients are calculated on redistribution criteria, such as population, regional income per capita, indicators of backwardness, etc., or they can take the form of grants. The drawback of equalisation is that if incentives are not designed properly, it might lead to moral hazard issues, where SCGs will not be encouraged to increase tax pressure, as their lower revenues are compensated by intergovernmental transfers.

Finally, stability (macroeconomic management) issues are mainly addressed through fiscal rules such as golden rules, balanced budget rules or borrowing rules. These fiscal rules should allow SCGs to provide the most efficient level of public goods, while making sure that SCGs' policies are consistent with national macroeconomic objectives.

National fiscal arrangements between levels of government vary widely, as they necessarily incorporate local economic, but also political, social and cultural factors. In the remainder of this paper, we will give a picture of these choices in the OECD countries, based on the research conducted by the OECD *Network on Fiscal Relations across Levels of Government*.

2.3 Allocating expenditures between levels of government

a) Assigning responsibilities for expenditure functions

The theory of assignment of functions to levels of government often begins from Musgrave's (1959) classification of government functions: redistribution, allocation, and stabilization. Oates (1972) suggests that the stabilization and redistribution functions should be assigned to the central level of government, while there is some role for SCGs in fulfilling the allocation function for certain types of public goods. The reasoning behind the above allocation of responsibilities is three-fold. First, macroeconomic stabilization depends on monetary and fiscal policies normally residing at the central level of government. Indeed, fiscal policy is thought to be more effective when used by national governments, and national spending and tax policies may also provide automatic stabilizers that cannot be implemented at the sub-national level (because of a higher cost of borrowing, or spillover effects of local spending on other sub national governments, which will deter local spending). Still, the global financial crisis has shown that SCGs' must be implicated in the national stimulus plans, and that they can also carry out efficiently their own stimulus plans when needed.[6]

Second, with respect to redistribution, it is very difficult for SCGs to redistribute in a world of mobile resources. Indeed, an attempt by a SCG to tax a mobile resource in order to redistribute to poorer mobile factors would result in the flight of the wealthy to avoid paying for the redistribution and an influx of the poor in order to benefit from it. This dynamic would tend to defeat the redistributive goal if pursued by SCGs. But as resources are less mobile internationally than within a country, central governments are in a better position to attain redistributive goals.

Finally, with respect to allocation, pure national public goods with economies of scale will benefit the most from cost-sharing and hence are clear candidates for central government provision. This is the case for example for defence, foreign affairs, interstate transport and telecommunications infrastructure, etc. Public goods that are subject to congestion and whose benefits are limited geographically will not benefit from cost-sharing and are therefore best provided by SCGs in order to take advantage of the ability of SCGs to more closely match regional public service delivery with local preferences. But SCGs will not take into account the possible externalities of their decisions on other regions (for instance, contagious diseases might have an impact outside the boundaries of a given SCG, but only the impact on its own residents will be taken into account,

[6] See Blöchliger & Alii (2010).

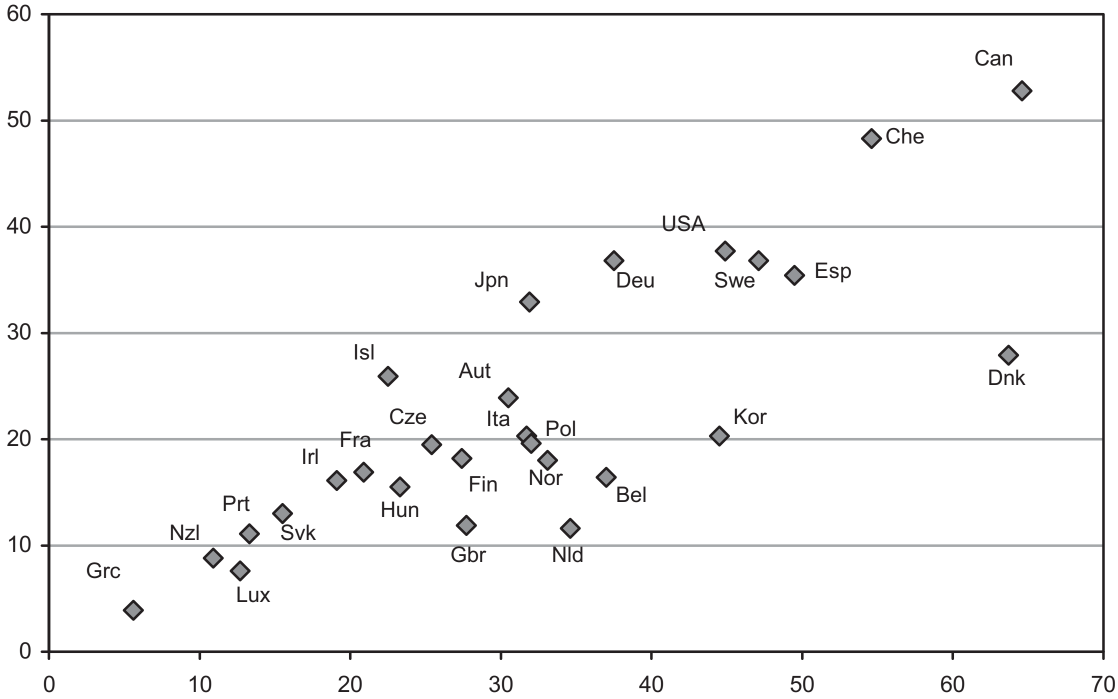
therefore leading to a lower level of spending on prevention if decided at sub-national level than the one that would be considered optimal on a nationwide scale).

Although there is general agreement on the normative principles outlined here, actual expenditure assignment usually leads to some overlapping in the assignment of responsibilities. Some areas, such as defence, foreign affairs, foreign trade, etc., must clearly be assigned to central governments, while in others such as local police, fire prevention, sanitation, etc., SCGs have much more information about local needs and preferences, and are therefore best suited to provide the goods. But many other expenses do not have such clear cuts, often leading to overlapping and ambiguities about which level of government is responsible for their provision. As there is no unique answer, this leads to a great variety of situations across countries. This situation was predicted by Mancur Olson's (1969) theory of "fiscal equivalence" in which he argues that it might be possible to define an "optimal" geographic size of government for each public service that corresponds to the boundaries that internalize all externalities. But as the boundaries of governments and the relative power of central government pre-exist (they are given by historical factors that do not take these issues into account), it seems almost inevitable that there will be over-lapping assignments of responsibilities as countries deal with the most efficient way to structure government.

b) Spending power of SCGs

The relative share of SCGs spending in total government spending varies greatly across countries, ranging from 6% in Greece, to almost 70% in Canada, with an average of 33% (Figure 2.1). But assigning spending responsibilities to SCGs is not enough to assure effective allocation efficiency. Indeed, sub-national spending might be strongly influenced by upper levels of government, thereby reducing their discretion over their spending, thus reducing their ability to allocate resources where they are most efficient at the local level. The commonly used measure of the relative share of sub-national spending to total government spending does not take this factor into account. It would therefore be useful to have a set of indicators of sub-national spending power autonomy, in order to assess how decentralisation affects policy outcomes like public sector efficiency or the long-term fiscal stability.

Figure 2.1. Share of sub-central governments in general government revenues and expenditure in OECD countries*



Note: Decentralisation is measured by the changes in the share of SCGs in total public revenues and spending.

1. Or latest year available: 2005 for Korea, New Zealand and Poland.
2. Excluding transfers received from other levels of government.
3. Excluding transfers paid to other levels of government.
4. The share of subnational revenues is expressed in percent of total government mainland revenues.

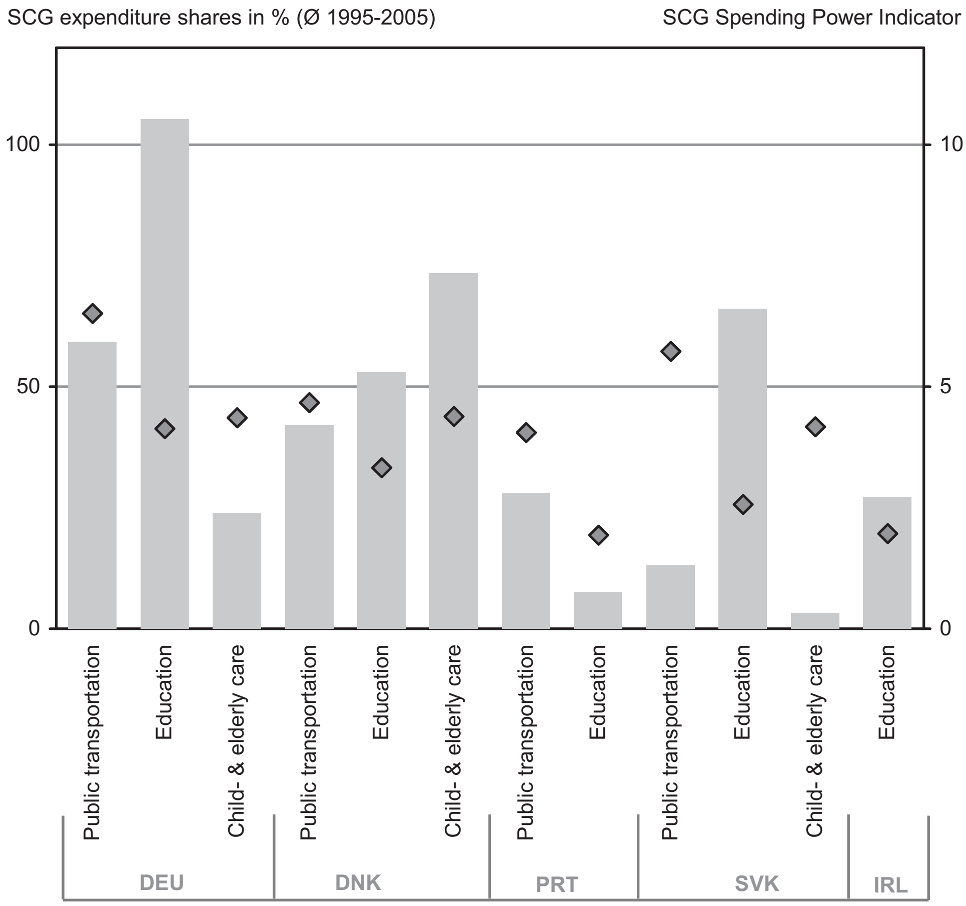
* General government revenues and expenditures are broken out between central government, sub-national governments (local and, when available, intermediate) and Social Security. As the share attributed to Social Security varies widely between countries (from 45.3% of spending in France to 4.4% in Denmark), this has a sigificant impact on the remaining shares attributed to central and sub-national governments.

Source: OECD National Accounts database; US Bureau of Economic Analysis.

There is no set of internationally comparable indicators of spending power (defined as the extent of control SCGs exert over their budget), except for very recent studies by the OECD. In particular, the OECD Network on Fiscal Relations across Levels of Government has recently done a pilot study on sub-national spending power indicators, by sending questionnaires to a sample of countries in the summer 2007 and spring 2008, focusing on four specific policy areas: education, public transport, childcare and elderly care (Bach, Blöchliger, Wallau, 2008).

The term "spending power" was defined for this study as the "ability of SCGs to shape, determine and change their spending policy", which means: to what extent do they set the rules and regulations that govern the services they provide? These rules and regulations were grouped into five categories: policy autonomy (are SCGs obliged to provide certain services?), budget autonomy (is expenditure autonomy limited by earmarked grants or expenditure limits?), input autonomy (staff management, salaries, right to tender or contract out services), output autonomy (standards setting for quality and quantity of goods provided) and monitoring and evaluation (to what extent do SCGs exert control over evaluation, monitoring and benchmarking?).

Figure 2.2. Comparing SCG expenditure ratios and SCG spending power indicators



Note: Bars and the left hand scale represent SCG expenditure shares in percent, dots and the right hand scale represent spending power indicators. The spending power indicator for "public transportation" is compared to the expenditure ratio for "economic affairs". The spending power indicator for (primary and secondary) "education" is compared to the expenditure ratio for "education". The mean of the spending power indicators for "child- and elderly care" is compared to the expenditure ratio for "social protection". Switzerland is not represented due to lack of COFOG I data. National Accounts data are unconsolidated.

Source: OECD (Bach, Blöchliger, Wallau, 2008).

Figure 2.2 compares the spending power indicators with the expenditure shares in the corresponding policy areas. It supports the hypothesis that simple expenditure ratios often poorly reflect effective sub-national spending power: whereas expenditure ratios frequently exceed 50%, the corresponding spending power indicator is rarely above the value of 5 (on a scale of 10), indicating that sub-national spending power is more limited than expenditure share suggests.

The conclusions of this preliminary study are the following:

- *Spending power indicators show relatively low SCG spending autonomy*: much sub-national spending is regulated or otherwise influenced by central government, and simple expenditure shares tend to overestimate actual sub-central spending autonomy;

- *Spending power is particularly low in education*, even though SCG spending share in this area is very large (above 50%);

- *Federal countries grant more power than unitary countries*.

2.4 Determining the size and type of revenues for SCGs

Financing public service delivery is also a shared responsibility between levels of government. SCGs have two main sources of funds: own taxes and transfers (fees usually make up for a low fraction of their revenues). Each of these types of revenues has different implications on the efficiency, equity and stability objectives, and therefore, the sub-national revenue mix will affect the final outcomes. In this section, we analyse the theoretical views of which taxes should be attributed to SCGs and which should be collected by central governments, and finally, what is the optimal level of discretion of SCGs over these resources (control over the tax rates and the tax base). Each time, we will confront these general principles with the actual practice in OECD countries.

a) Revenue structure of SCGs: taxes vs. grants

The "Fiscal gap" (the difference between SCGs expenditures and revenues) can be quite large in some countries, and several OECD reports show that this vertical imbalance has widened during the last decade (Mizell, 2005). As this vertical imbalance is mostly covered by grants, the reliance of SCGs towards grants has increased.[7] What implications does this have on the efficiency, equity and stability objectives?

The mainstream view is that SCGs spending should essentially be covered by own tax revenues. Indeed, own taxes improve resource allocation and management efficiency, as citizens will put more pressure on SCGs to be more efficiency oriented and more responsive to their tastes and preferences when they actually pay for the goods and services provided. For efficiency considerations, the last dollar of spending should be financed by own-tax, so that citizens only demand an extra service if they value it at more than the cost of providing it. Own taxes are also considered to promote democratic accountability, since those that benefit from public services decide on taxation levels and finally pay the bill. Finally, a high reliance on own-resource revenues provides SCGs with incentives to growth-oriented economic and fiscal policies, since they may fully reap their financial benefits.

But Figure 2.3 below shows that on average, only about half of SCG revenue is covered by own taxes, the other half being covered by intergovernmental grants. Of course, this average hides a large variation, with own tax revenues representing up to 90% of SCGs revenues in Iceland, and as little as 13% in the Netherlands. In general terms, federal countries tend to allocate a slightly higher own tax share to their SCGs than unitary countries.

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[7] See Blöchliger, H. and Vammalle, C. (2009), "Grants systems in OECD countries: trends and some policy issues", Paper prepared for the KIPF Meeting in Copenhaguen, September.

Figure 2.3. Revenue composition of SCG, 2005 (in percentage of total SCG revenue)

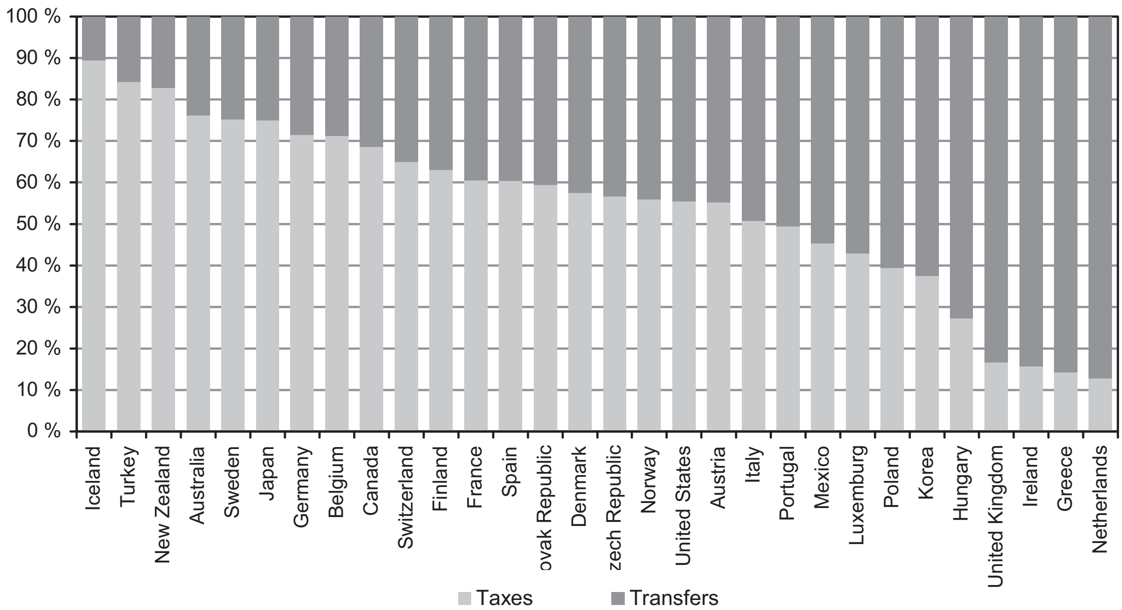
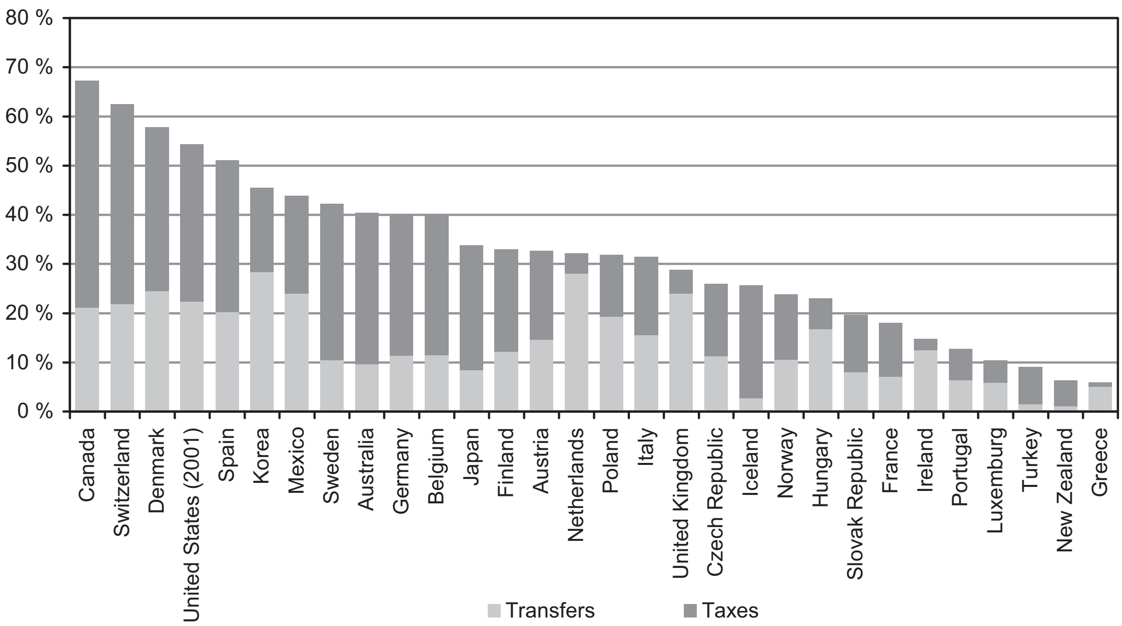


Figure 2.4. Revenue composition of SCG, 2005 (in percentage of general government revenue)



Source: OECD (2008/5)

b) Which taxes for SCGs?

It is generally agreed that SCGs should rely on taxes levied on relatively immobile assets (such as property), in order to avoid tax-induced migrations of factors of production, and on relatively stable assets, to avoid large SCG's budget fluctuation. Therefore, central governments are usually assigned the taxes levied on the most mobile factors, taxes with the higher income elasticity, and taxes levied on tax bases that are distributed unevenly across countries (Ter-Minassian, 1997). According to these criteria, income taxes on enterprises should be assigned to central government, while taxes on individuals and households (such as income taxes or property taxes) are more suited for SCGs, as these are seen as less mobile than enterprises. Taxes on natural resources and on foreign trade are usually assigned to central governments, as well as multi-stage sales taxes (such as VAT), as coordination problems between regions would make their management very difficult for SCGs.

Table 2.1 below shows that indeed, income taxes on individuals represent the largest share of SCGs' tax revenues, with more than 35% on average. The second largest taxes are taxes on property, with 27%, and third come taxes on goods and services, which represent 21% of total SCGs' tax revenues.

Table 2.1. Composition of SCGs' own taxes

Type of tax	As % of total SNG taxes
1000 Taxes on income, profits and capital gains	41.7
1100 Of individual	35.5
1200 Corporate	5.9
1300 Unallocable between 1100 and 1200	0.3
2000 Social security contributions	0.3
3000 Taxes on payroll and workforce	3.3
4000 Taxes on property	27.3
5000 Taxes on goods and services	21.4
6000 Other taxes	5.9

Note: Unweighted average. Countries included are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Italy, Japan, Korea, Mexico, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and Turkey.

Source: OECD (2006).

c) Tax autonomy

For most countries, taxes represent the largest share of SCG revenues, but what is the actual discretion of SCGs over this source of revenues? What is SCGs' right to introduce or abolish a new tax, to set tax rates, to define the tax base, or to grant tax allowances or reliefs to individuals and firms? The OECD Network on Fiscal Relations across Levels of Government has developed a series of indicators to measure the level of SCGs' tax autonomy (Blöchliger, King, 2006; Blöchliger, Petzold, 2009).

Taxing power indicators developed by the OECD measure the degree of own-taxing power of SCGs by capturing the degree to which SCGs can set their own tax rates and bases. In a number of countries, taxes are not assigned to one specific government level, but shared between the central and SCGs. Such tax-sharing agreements deny a single SCG any control on tax rates and bases, but collectively, SCGs may negotiate the sharing formula with central government. The OECD Network on Fiscal Relations across Levels of Government has developed a set of institutional indicators to estimate tax autonomy. The framework consists of five main categories of autonomy, ranked in decreasing order from highest to lowest taxing power (from left to right in Table 2.2). The category "a" represents full power over tax rates and bases, "b" represents power over tax rates, "c" power over the tax base, "d" tax-sharing agreements, and "e" no power on rates and bases at all. Each of these categories is again divided into sub-categories up to a total of 13 different categories.

The average results are presented in Table 2.2, for the year 2005. They show that although tax autonomy varies widely across countries, most SCGs have considerable discretion over their own taxes: on average, the tax revenue share with full or partial discretion (categories a, b and c) amount to more than 50% for state and almost 70% for local governments.

Table 2.2. Summary of taxing power of SCGs, 2005

	SCG tax revenue		As share of SNG tax revenues										
			Discretion on rates and reliefs	Discretion on rates		Discretion on reliefs	Tax-sharing arrangements Revenue split set:				Rates and reliefs set by CG		
Unweighted average	as % of GDP	as % of total tax revenue	(a)	Full (b1)	Restricted (b2)	(c)	by SNG (d1)	with SNG consent (d2)	by CG, pluriannual (d3)	by CG, annual (d4)	(e)	Other (f)	Total
State	6.9	19.8	45.3	0.3	8.2			19.9	18.4	4.7	1.8	1.4	100
Local governments	4.5	11.8	14.6	22.5	31.5	0.3		2.9	16.4	0.8	6.0	5.0	100

Source: OECD (2008/7)

The data of tax autonomy by tax type reveals that autonomy varies according to the tax type, in both levels of SCG (state and local). Property taxes are usually assigned more discretion than other taxes, with almost all tax revenue in category a and b. Around a quarter of income tax revenue is embedded in tax-sharing systems, which restrict a single SCG's control over this tax. Taxes on goods and services are even more embedded in tax-sharing arrangements than income taxes, and so provide a relatively small part of the tax revenues under the full control of SCGs (Blöchliger, Petzold, 2009).

Tax-sharing arrangements are something of a hybrid between decentralized and centralized revenue sources for SCGs and in practice, are difficult to distinguish from grants.[8] Tax-sharing formulas are not simply a division of revenues, but can involve complex formulas that are similar to grant formulas. Equally, intergovernmental grants are sometimes little more than a share of national taxes. The National Accounts and Revenue Statistics provide some guidelines, but it is entirely possible that reported tax-sharing in one country would be reported grants in another. In terms of their economic effects, tax-sharing arrangements are almost indistinguishable from grants. Since SCGs do not set the rate or base, countries with tax-sharing arrangements cannot take full advantage of one of the main benefit of decentralisation, the offering different public service-tax packages to satisfy diverse tastes. But on the other hand, the pooling of taxes tackles potential drawbacks of local taxation, such as income volatility and mobility of the tax base. Fiscal equalisation elements, which are often built into tax-sharing arrangements, suffer from the same incentive difficulties as equalizing and formula-based grants, which are discussed below.

d) Intergovernmental Grants

Intergovernmental grants can be of different types (Box 2.1 describes the OECD typology of grants), and respond to three types of objectives:

- **Financing sub-national services and investments**: In most countries, spending by SCGs is larger than their revenues. Grants are therefore used to fill the gap between SCGs' revenues and spending responsibilities.

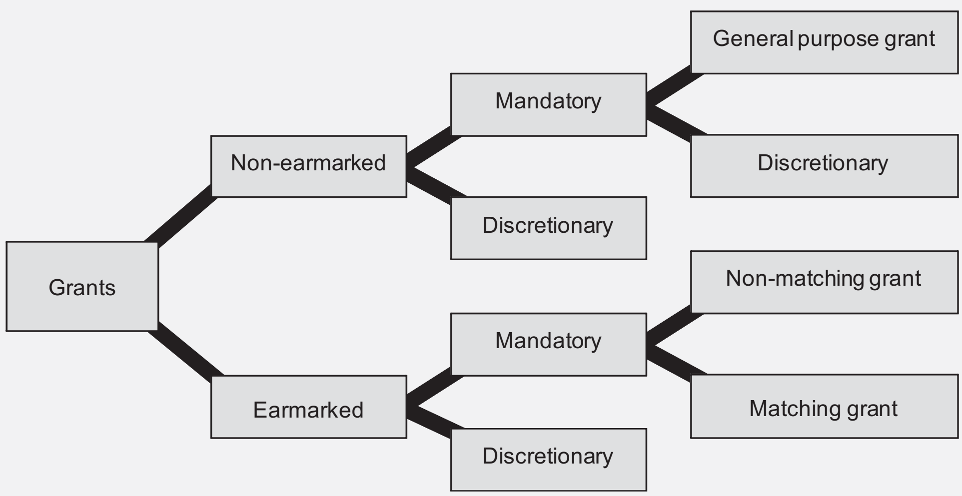
- **Equalisation**: While taxes are preferable to grants in terms of efficiency and accountability, a high reliance on own tax revenues for SCGs might raise equity concerns. Indeed, tax raising capacity is usually unevenly distributed across sub national governments, which could lead to different levels of public service delivery across regions or to different levels of tax burdens on

[8] See Blöchliger, King (2006) and Blöchliger, Petzold (2009) for some attempts to draw a line between grants and tax-sharing agreements.

citizens. Equity concerns might then arise, and the central government might prefer SCGs to provide the same basic bundle of services with roughly the same tax effort. Intergovernmental "equalisation" grants are then used to redistribute wealth from richer to poorer regions.

- **Correcting externalities (subsidisation)**: Grants can also be used to correct potential fiscal externalities or "spillovers". Such externalities arise when the fiscal policy of one sub national government affects outcomes in other sub national governments. Grants (mainly matching grants) are then used to change the price of providing public goods, in order to internalize the externality.

Box 2.1 The OECD typology of grants



Earmarked and non-earmarked grants

Grants can be either earmarked or non-earmarked. An earmarked grant is a grant that is given under the condition that it can only be used for a specific purpose. Non-earmarked grants can be spent as if they were receiving SCG's own (non-earmarked) tax revenues.

Mandatory and discretionary grants

Both earmarked and non-earmarked grants can be either mandatory or discretionary. Mandatory grants (entitlements) are legal, rules-based obligations for the government that issues the grant. This requires that both the size of the grant and the conditions under which it is given be laid down in a statute or executive decree and that these conditions be both necessary and sufficient. Typically, SCGs can also appeal to a court or administrative judicial authority in order to obtain the grant. Most grants that are given to SCGs on a regular basis are mandatory. The size of discretionary grants, and the conditions under which they are given, are on the other hand not determined by rules but decided on an ad hoc, discretionary basis. Discretionary grants are often temporary in nature and include, for example, grants for specific infrastructural projects of emergency aid to a disaster area.

Matching and non-matching grants

Earmarked mandatory grants can be either matching or non-matching. Matching grants complement sub-national contributions. Matching grants are dependent on normative or actual spending for services for which the grants are earmarked, or on local revenue collection related to these services. All mandatory earmarked grants that are not given complementary to sub-national contributions are non-matching. The decisive question to determine whether a grant is matching or non-matching is whether the decrease in sub-national spending would automatically lead to a decrease in the grant.

General purpose and block grants

Non-earmarked mandatory transfers can be general purpose or block grants. Both types are similar in that they increase the SCGs' revenues without changing relative prices in the provision of services. The difference is that a block grant is given by the grantor for a specific purpose (or purposes). However, since the grant is not earmarked, the grantee's actual use of the grant is not controlled. Instead, the output could be regulated through, for example, a set minimum standard that the SCG would have to provide. In this case, resources are transferred in the form of a grant to the SCG to cover all or part of the cost for certain sub-national services. The criteria used to calculate the level and distribution of the grant are usually connected to the normative cost of providing the goods or services for the sector as a whole, using variables that a specific SCG cannot directly control. The rationale for this type of grant is to improve efficiency in the use of resources at sub-national level, whereas the activity is financed, in part or fully, by the central government. If a sub-national unit is able to perform the activity at lower than normative costs, the grant will not be reduced for that unit as a consequence, thereby giving the SCG an incentive to fully explore the advantages of decentralised service provision. This kind of grant can be a means of moving away from earmarked grants.

Source: Bergvall et al. (2006)

i. Financing sub-national services

On average, earmarked transfers constitute about half of grants for both the state and the local level of government (Table 2.3). These average numbers hide a very large variation across countries, with earmarked grants representing as much as 94% in Australia, and as low as 17.6% in Spain (Blöchliger, Petzold, 2008). Table 2.3 also shows that most earmarked grants are matching, both at state and local government levels.

Table 2.3. Average grant revenue by type of grant, 2006 (as a percentage of total grant revenue)

<table>
<tr><th rowspan="3">Unweighted average</th><th colspan="4">Earmarked</th><th colspan="3">Non-earmarked</th></tr>
<tr><th colspan="2">Mandatory</th><th colspan="2">Discretionary</th><th colspan="2">Mandatory</th><th rowspan="2">Discretionary</th></tr>
<tr><th>Matching</th><th>Non-matching</th><th>Matching</th><th>Non-matching</th><th>General purpose</th><th>Block grants</th></tr>
<tr><td>State</td><td>18.8</td><td>13.7</td><td>8.5</td><td>9.3</td><td>48.2</td><td>0.2</td><td>1.1</td></tr>
<tr><td>Local</td><td>27.7</td><td>5.6</td><td>3.0</td><td>16.3</td><td>39.3</td><td>3.0</td><td>3.0</td></tr>
</table>

Source: Blöchliger, Petzold (2008)

Functions financed by earmarked grants vary significantly between countries (Table 2.4). On average, the most important functions are education (21%), general public services (17.4%) and social protection (16.7%), but these averages hide a large variation between countries, with education representing only 7.5% of grants in Hungary for instance, and more than 60% in Mexico.

Table 2.4. Grants by government function, 2006 (in percent of total earmarked grants)

	Defence	Economic affairs	Education	Environment protection	General public services	Health	Housing and community amenities	Public order and safety	Recreation, culture, religion	Social protection	Total
Australia	-	14.9	36.5	-	-	37.1	3.6	0.2	0.0	7.8	100.0
Austria											
Belgium	-	-	55.6	-	-	3.9	22.2	-	-	18.3	100.0
Canada											
Czech Republic											
Denmark											
Finland											
Germany											
Greece	-	22.4	-	6.3	43.1	-	6.1	-	7.9	14.2	100.0
Hungary	0.1	3.8	7.5	7.3	18.8	4.4	32.6	-	5.7	19.7	100.0
Iceland											
Ireland											
Italy	-	46.9	8.1	2.8	12.4	27.0	2.9	-	-	-	100.0
Japan											
Korea											
Luxemburg	-	2.2	7.0	0.5	72.8	-	6.0	0.5	6.3	4.8	100.0
Mexico	-	-	63.8	1.8	5.7	10.3	-	8.7	-	9.6	100.0
Netherlands	-	0.6	12.7	10.1	3.4	-	6.0	0.1	9.3	57.7	100.0
New Zealand											
Norway											
Poland											
Portugal											
Slovak Republic											
Spain	-	28.9	16.3	-	23.9	5.2	3.9	7.9	0.5	13.2	100.0
Sweden											
Switzerland	0.4	51.3	13.1	2.7	-	0.0	-	1.0	0.2	31.3	100.0
Turkey											
United Kingdom											
United States[1]	0.8	3.6	10.4	1.1	11.0	48.9	11.7	1.1	-	6.5	95.1
Unweighted average	0.1	15.9	21.0	3.0	17.4	12.4	8.6	1.8	2.7	16.7	99.5

1) Not including the heading “Other grants” that could be classified in one of the above categories.
Source: Blöchliger, Petzold (2009)

ii. Fiscal equalization

One of the most important roles of intergovernmental grants is to reduce differences in tax raising capacity and public service needs across sub national governments. Most countries have introduced explicit or implicit equalization systems using either vertical transfers to financially weak SCGs, or horizontal transfers from financially strong to financially weak SCGs (Bloechliger and Charbit, 2008). Fiscal equalization is defined as “a transfer of fiscal resources across sub national governments with the aim of offsetting differences in revenue raising capacity or public service cost. Its principal objective is to allow sub-central governments to provide their citizens with similar sets of public services at a similar tax burden” (Blöchliger, Merk, Charbit, Mizell, 2007). Box 2 below describes the main reasons for equalization.

Box 2.2. Main reasons for equalisation

Equity
To equalise per capita tax revenue raising capacity and the per-beneficiary cost of providing public goods and services across regions. Tax raising capacity per capita and cost of providing public services can differ across regions for geographic or socio-economic reasons. The objective of equalisation is to provide every citizen with an average level of public services at comparable tax rates.

To equalise the marginal benefit of public spending across regions. OECD countries that have central government programs for important public services (such as health and education) administered by sub-central governments, may use equalising transfers to equalise the marginal social benefit of public spending across regions.

Externalities
To avoid fiscal externalities resulting in a misallocation of labour and/or capital across regions. A decentralised fiscal system could distort the location decision of mobile factors. Unequal tax bases result in pecuniary incentives to locate in high tax base regions, thereby distorting location decisions of mobile factors of production. Grants that equalize tax bases across regions will eliminate this source of inefficiency.

Insurance
To provide insurance against asymmetric income or employment shocks. If the regions of a country are subject to asymmetric shocks, redistributive

grants may provide regions with insurance against the adverse effects of such shocks on income or employment.

In all countries, the driving force for equalisation is equity, i.e. having similar tax raising capacity and equal access to public services across sub national governments.

Source: Blöchliger, Merk, Charbit, Mizell (2007)

On average, equalisation represents 2.3% of GDP (Table 5), but ranges from 0.5% in Australia and Norway, to 4% in Japan. It represents on average 4.8% of total government expenditures, and about 55% of intergovernmental grants. All grants do not have an equalisation objective. Are considered equalisation grant only those fiscal arrangements that provide greater transfers per resident to SCGs with below-average tax revenue-raising capacity, or greater transfers per resident to SCGs with above-average public service cost, even though this last distinction proved difficult for some countries (Blöchliger, Merk, Charbit, Mizell, 2007). The coefficient of variation gives a picture of regional disparities. It measures the variability of GDP per capita per region in a given country. Table 2.5 shows that fiscal equalisation considerably reduces disparities, from an average of 30% to less than 10%. In some countries, such as Australia and Sweden, disparities are actually reduced to zero. After equalisation, fiscal disparities are clearly below economic disparities as measured by regional GDP, meaning that the potential to provide public services is more evenly distributed than economic wealth (Blöchliger, Merk, Charbit, Mizell, 2007).

Table 2.5. A snapshot of fiscal equalisation. Equalising grants and their fiscal disparity-reducing effect

	Size of the equalisation system (in percent)			Effect on fiscal disparities (variation coefficient)		
	Percent of GDP	Percent of government expenditure	Percent of intergovernmental grants	Disparities before equalisation	Disparities after equalisation	Difference
Federal/Regional Countries						
Australia	0.5	1.4	19	16.8	0.0	16.8
Austria	3.8	7.6	69	-	4.2	-
Canada	1.0	2.5	24	29.8	20.1	9.7
Germany	2.0	4.2	45	13.0	2.7	10.3
Italy	3.0	6.3	48	39.0	6.0	33.0
Mexico	3.7	-	78	-	-	-
Spain	3.0	7.6	67	26.5	10.1	16.4
Switzerland	3.0	8.2	80	31.8	23.2	8.7
Unitary Countries						
Denmark	2.8	5.1	23	16.0	6.0	10.0
Finland	3.8	7.4	71	17.7	4.2	13.4
Greece	1.2	2.4	75	-	-	-
Japan	4.0	11.0	-	36.0	-	-
Norway	0.5	1.2	11	23.0	8.0	15.0
Portugal	1.8	4.0	81	90.0	28.0	62.0
Sweden	2.6	4.6	50	10.0	0.0	10.0
Turkey	1.1	-	82	39.0	14.0	25.0
Unweighted average	2.3	4.8	55	29.9	9.7	19.2

Source: Blöchliger, Merk, Charbit, Mizell (2007)

Equalisation thus seems to improve equity. Nevertheless, equalisation also has some drawbacks.

- On the revenue equalisation side, equalisation can have negative incentives on a SCG's tax efforts. Indeed, for richer SCGs, an increased tax effort will be equalised away, as a share of the extra revenues will be transferred to poorer sub national governments. The higher the equalisation tax rate[9], the bigger the incentives for strategic tax rate setting (such as avoiding taxes that enter the equalisation formula, etc.). Besides, by guaranteeing a minimum fiscal capacity to all SCGs, equalisation might deter poorer regions from developing their economic and fiscal base. Possible solutions are to include only part of SCGs' tax revenues in the equalisation formula, or to base equalisation on other criteria than fiscal revenues, such as the regional development programmes in Italy, where a part of investment support is linked to a region's performance in selected policy areas (Blöchliger, Merk, Charbit, Mizell, 2007).

- Cost equalisation tends to be rather complex and difficult to manage. Indeed, the cost of services varies across regions due to a number of different factors: geographic location, population size and concentration, demographic characteristics, etc. Objective criteria must be selected to explain cost differences, and cost equalisation schemes easily open the door to rent seeking and potential over estimation of expenditure needs, and therefore, of equalisation payments (see Boxes 2.3 and 2.4 for the Austrian and Japanese experiences). Indeed, if there can be objective reasons for production costs to be higher in certain regions than in others, these differences might also be due to inefficient structures and institutions. In the long run, a compensation for higher costs might therefore reduce service providers' interest in developing cost-saving technologies.

[9] The concept of "marginal equalisation rate" (or "equalisation tax", "tax back" or "compensation rate") is defined as the amount of money a SCG loses (wins) if it increases (decreases) its own tax revenue by 100 monetary units).

Box 2.3. Equalisation tax rates in Austria

Some Austrian municipalities with weak fiscal capacity face equalisation tax rates exceeding 100 percent. The comprehensive and complex Austrian fiscal equalisation is embedded in a tax-sharing system that covers both the state and the municipal level. Shared taxes are distributed across the Länder according to population mainly and a factor representing tax shares of the past, and to the municipalities according to various criteria such as fiscal capacity, expenditure needs and a scale factor favouring larger municipalities. Altogether five distinct equalisation schemes govern the allocation of the equalisation grant to the individual municipality, each with different tax and expenditure bases. As the equalisation formulas interact, a municipality's overall loss in equalisation grants may in some cases be greater than its gain in additional tax revenue resulting from development efforts. Since the disincentive is larger for poorer than for wealthier municipalities, and since policy makers at the Länder level tend to favour development in municipalities with a low equalisation tax rate (Schneider, 2002), Austrian municipal equalisation may in the long run exacerbate.

Source: Blöchliger, Merk, Charbit, Mizell (2007)

Box 2.4. Service capacity equalisation in Japan

Sub-national authorities should not be able to influence the criteria for service cost equalisation. This requirement is not entirely met in Japan, where at least part of the borrowing by SCGs (and consequently the worsening of Japanese public finances) can be ascribed to the fact that road construction volumes and interest payments are important distribution criteria for the non-earmarked grant (the LAT, local allocation tax). Each of these criteria creates an incentive for Japanese prefectures to borrow and overspend on roads. Other OECD member countries where road construction volumes constitute an important distribution criterion for the equalisation grant are Portugal, the Slovak Republic and Denmark. In the latter country, the number of local road kilometres was a criterion for the need for road spending during the 1980s. Local authorities then began to turn small, private dirt roads into public roads. This led to much more equalisation compensation than the costs of maintaining the dirt roads (which only involved a truck and some gravel every second or third year).

The criterion was later abandoned. The reason for the wrong incentives is that the grants do not equalise service capacity (the need for roads or borrowing) but the actual level of road construction or borrowing.

Source: Blöchliger, Merk, Charbit, Mizell (2007)

iii. Correcting externalities

Fiscal externalities arise when the fiscal policy of one SCG affects outcomes in other SCGs. In these cases, SCGs do not take into consideration the full social effect of their decisions, as they only consider the impact on their own constituents[10]. Externalities may arise on the spending side, for example, when one SCG finances public infrastructure that will also benefit the residents of neighboring SCGs. Or they can arise on the revenue side (tax externalities), when a SCG's tax policy affects the residents of other regions, for example, by tax exporting (trying to have non-residents paying local and regional taxes) or by tax competition (lowering the tax rate to attract firms). Grants can be used to correct for these externalities. Matching grants are often used to compensate local authorities for the extent of benefit spillovers across administrative boundaries. By lowering the cost of the public good (as they complement SCGs spending, SCGs only face part of the cost of providing the good or service), they give incentives to the SCG to provide higher levels of public services to non-residents. Still, an OECD study (Blöchliger, Petzold, 2008) has shown that the real scope for externality correction is rather limited, and probably much smaller than the size of the matching grants created to correct them. Thus, it seems that the size and structure of grants, and particularly matching grants, depend more on political economy factors rather than purely fiscal considerations.

But regional spillovers are not necessarily handled through grants: other possible ways to solve regional spillover problems are to increase the size of SCGs, or to charge non-residents a differentiated rate for the use of services[11]. Some OECD countries have also used inter-municipal fiscal contracts. Voluntary contracts are preferable, but often difficult to put in place, because SCGs that benefit from positive spillover effects might be tempted to free-ride, and avoid paying the costs. Grants can then be designed to encourage cooperation between sub-

[10] SCGs do not fully perceive the social marginal costs and benefits of their taxing and spending decisions.

[11] This of course requires excludability, i.e. that it be possible to prevent people from using the service if they do not pay for it (some public goods such as public lightning are not excludable: once they are provided, everybody can enjoy them).

national units of government, as the EU LEADER Programme (*Liaison Entre Activités du Développement de l'Economie Rurale*), which aims at bringing an integrative approach to rural development. It attempts to use subsidies to encourage public-private and intergovernmental cooperation through innovative multi-sector projects. France has also an interesting program of inter-municipal cooperation (Box 2.5).

Box 2.5. French support for co-operation

Intermunicipal co-operation has been and remains an important element of most national programmes. This is especially true in France where there are more than 36 000 municipalities and where mergers are resisted by local politicians and citizens and are not promoted by the central government. In order to increase the scale of local service provision, the French authorities have favoured the use of incentives to encourage co-operation. These incentives were systematised in 1999 with central support for "structures à fiscalité propre" (intermunicipal structures with their own tax), even if other types of intermunicipal structures remain. The principle is the following: the intermunicipal bodies continue to be voluntary structures; the parent communes have 10 years to progressively converge towards the same business tax rate (the most important local tax) and the "losers" in this converging process receive compensatory payments; the tax rate is decided by the intermunicipal body which will also directly receive the tax revenue. In order to stimulate local authorities to participate in these structures, the French government pays a supplementary grant to the EPCI (établissements publics de coopération intercommunale) in addition to the general purpose grant to all sub-national levels, the DGF (dotation globale de fonctionnement). This supplement is called the "dotation d'intercommunalité" (intermunicipal grant), and its size depends upon the type of EPCI. Six years after the launch of this new programme, 84% of the French population lives in an area covered by an EPCI with its own tax revenue (88% of French municipalities are located in these areas).

Source: Bergvall, Charbit, Kraan, Merk (2006)

2.5 Managing macroeconomic stability: fiscal rules

Decentralising expenditure capacity to lower levels of government can have positive effects on efficiency, as local governments are more aware of local needs and tastes than central governments. But this can also undermine global macroeconomic stability, as SCGs do not always take into account the effect of their fiscal decisions on the rest of the country on the one hand, and might even have incentives to overspend on the other hand. Fiscal rules are therefore needed, in order to reduce this possible risk. Fiscal rules are defined as a set of institutional constraints on policymakers' decision-making discretion. Such rules may be imposed on SCGs by a higher level of government, or SCGs may adopt them themselves, where constitutional arrangements grant them the autonomy to do so (Sutherland, Price, Joumard, 2006).

We have shown that the increase in SCGs spending responsibilities has been larger than the increases in their tax autonomy. SCGs do not bear the whole costs of the public goods and services they are responsible for, thus creating incentives for overspending. If SCGs are allowed to borrow on capital markets, they might face interest rates that do not fully reflect their credit risk (as lenders perceive that their borrowing is implicitly guaranteed by central government), thus leading to possible over-borrowing. If investors anticipate a bailout in case of default by a SCG, fiscal decisions of one SCG will impact on the borrowing costs of the other SCGs and of the central government, reflecting a higher overall risk of default. Sound SCGs fiscal policies are therefore crucial for the macroeconomic stability of the whole country. Four types of rules can be used to support fiscal sustainability and short-term stability: balanced budget requirements, borrowing constraints, tax and expenditure limits (TEL) and process and implementation regulations.

- *Balanced budget requirements* in OECD countries vary according to whether they are applied to the current budget and/or the capital account (balanced budget requirement applied only to the current budget, thus allowing borrowing to finance net investments is usually referred to as the "golden rule" of public finance); whether they are set annually or multi-annually; and whether they are imposed from above or self-imposed. Most commonly, balanced budget requirements are applied to current and capital budgets, are set annually, and are imposed from above.

- *Borrowing constraints* are widely used in OECD countries, but with a substantial variation in terms of restrictiveness. They range from total prohibition (Denmark and Korea) to no restriction at all. In most cases, SCG borrowing requires prior approval by higher levels of government, and is often restricted to certain purposes (such as investment). Box 2.6 gives some examples of borrowing constraints in OECD countries.

- *Tax and expenditure limits*. Overall limits on tax rates or reliefs are widely used in OECD countries, and usually take the form of an explicit limit on tax autonomy set by central government (see Table 2.2). Expenditure increase limits are usually linked to income, inflation of population growth. But explicit, binding, expenditure limits are rather rare (they exist only in Germany, Korea, Portugal and Turkey). In some countries such as Japan, the Netherlands, Poland and Spain, expenditure limits are not imposed by central government, but self imposed.

- *Process rules* that govern implementation will determine the degree of commitment of SCGs to the set of rules described above (indeed, without a proper commitment mechanism, SCGs could either ignore, or change the rules binding their autonomy). Process rules include the obligation to produce financial accounts (transparency), monitoring and reporting, and eventual sanctions in case of non compliance. But process rules should also allow for flexibility of response, as breaking the fiscal rules might be the appropriate response to an unanticipated shock such as large revenue shocks, downturns in the local economy, the impact of natural or other disaster, etc. This is why many countries incorporate escape clauses that allow SCGs to breach the rule in case of certain predetermined events.

Box 2.6. Examples of borrowing constraints in OECD countries

Borrowing constraints cover a range of restrictions on sub-central government recourse to debt financing. With the exceptions of Australia, Canada, Spain (states) and Switzerland, a higher level of government typically imposes these constraints.[12] In the most restrictive cases, borrowing may not be allowed at all (as in Denmark, or in Korea and Spain for current expenditure). In Poland, no borrowing is allowed if general government debt levels exceed 60% of GDP. The requirement of prior approval from higher levels of government is also quite widespread, including permission to borrow in foreign currency as in Mexico and Turkey. The need for prior approval on a project-by-project basis is gradually being relaxed in OECD countries, such as Mexico which abandoned such a system in 2000. In Japan and Korea the formal requirement to obtain permission from a higher level of government is being relaxed. In Norway and Spain, prior authorisation can be imposed when sub-central governments breach agreed deficits or the proposed borrowing is substantial. In Belgium, in large part due to complicated inter-governmental relations, there are no explicit sanctions for breaching consensual targets

[12] In Germany, the Länders' access to borrowing is almost totally unconstrained. Technically, there is a provision to limit borrowing to prevent major macroeconomic disturbances, but this has never been invoked.

set by the Conseil Supérieur des Finances (CSF) for each local government and local government as a whole. However, legislation permits the federal government to limit borrowing by non-compliant regions for two years.[13] A few countries apply limits on borrowing for specific purposes. For example, in Spain, local authorities can borrow up to 30 per cent of current revenues to cover short-term liquidity needs, while long-term borrowing is restricted to capital investment. No constraints on access to borrowing are applied in the Czech Republic, Finland, the Netherlands, and Japan. In interpreting this information, it should be kept in mind that strict budget balance requirements (see Table 2.1) may also have the effect of outlawing in practice the need for borrowing constraints.

Source: Sutherland, Price, Joumard (2006)

The need for fiscal rules is influenced by three factors: expenditure assignments, revenue assignments and financial market oversight.

- *Expenditure assignment.* Fiscal rules are particularly important when SCGs are responsible for large and politically sensitive areas such as health, education or social welfare, as it may then be difficult for central governments to resist bailing out deficit-prone SCGs. However, fiscal rules limiting SCGs' spending autonomy must not reintroduce central direction, which would then undermine the benefits from decentralising spending decisions.

- *Revenue assignment* (the extent and sources of SCGs' income) also affect the need for fiscal rules: the more SCGs depend on transfers, the more fiscal rules (such as borrowing constraints) are needed to compensate for the lack of matching between the benefits from spending, and the weight from financing these expenditures. For those SCGs with higher tax autonomy, tax competition can be a positive factor in keeping deficits small without the need for fiscal rules.

- Finally, *financial market oversight* might substitute for other monitoring mechanisms by imposing higher borrowing costs to profligate SCGs. However, this market discipline requires that central governments credibly

[13] Maintaining limits on deficits was important due to the vertical fiscal gap that opened during the process of decentralisation. More recently, as greater revenue sources have been assigned to sub-central governments, macroeconomic considerations would suggest they target minimum surpluses.

commit not to bailout defaulting SCGs. Besides, the adoption of fiscal rules limiting their deficit and debt levels may still be used by SCGs as signals of fiscal discipline in order to obtain lower interest rates.

Depending on their expenditure assignment, revenue assignments, and the importance of financial market oversight, each country has developed its own set of fiscal rules. Box 2.7 below describes the particular case of Switzerland.

Box 2.7. Fiscal rules in Switzerland

Switzerland is a highly decentralised federal country, where the cantons are autonomous in all the spheres of competences where the confederation is not authorised by the constitution. This constrains the ability of central government to impose fiscal rules on sub-central governments (and as a result the confederation can face difficulties in conducting counter-cyclical fiscal policy). The confederation changed the constitution in 2001 to the effect that the budget is balanced over the cycle, but this "debt brake" does not apply to the cantons.

There is considerable variety in the cantons' own fiscal rules and the rules they impose on their communes. For example, 13 cantons have their own "debt brakes" of various degrees of restrictiveness and requirements to hold referenda on expenditure vary across the cantons. The cantons determine budget balance objectives and debt service limits for the communes. In some cases, the cantons are responsible for deficits experienced at the communal level.

A number of studies have identified features that have helped restrain the growth in the size of government. These include most notably the institution of direct democracy (the requirement to hold referenda on expenditures that exceed certain thresholds). Tax competition between the cantons has helped maintain pressure on policymakers to keep rates low, particularly on the more mobile tax bases. As a result, the argument that sub-central government have a tendency, from political myopia, to tax inefficiently or excessively has not been an important motivation for fiscal rules in Switzerland. Other factors that lead to smaller government include the small size of the cabinet, bodies that oversee the finance commissions and, in some cantons, rules that debar bailouts of communes (Schaltegger and Feld, 2004; Schelker and Eichenberger, 2005; and Blankart and Klaiber, 2005). And a recent federal court ruling that a canton (Valais) did not have the obligation to bail out a delinquent commune (Leukerbad) has further strengthened the position of the cantons vis-à-vis the communes and enhanced the potential monitoring and sanctioning role financial markets can play.

Notwithstanding these aspects of the fiscal policymaking landscape, during the 1990s, the growth of sub-central government as a share of GDP increased and liabilities almost doubled in real terms. This occurred despite most cantons having adopted recommendations contained in the Conference of Cantonal Ministers of Finance's Handbook of Public Budgeting to balance their budgets over the business cycle and to reduce debt over a 10-year period. The growing debt levels provoked over a third of cantons to introduce new limitations on the accumulation of debt. These "debt brakes" have proven to be successful at preventing deficits (Feld and Kirchgässner, 2004, 2005). Another source of pressure has been exposure to guarantees given to canton owned banks. The recent experience of a few cantons having to bail out publicly owned banks has led to a reassessment of these types of guarantees.

The problems of the 1990s emerged because the existing fiscal rules were ill adapted to cope either with cyclical variations in revenue or the secular upward pressures on spending (Bodmer, 2004). Direct democracy by voting on new spending is weak in addressing growing programme spending. Thus, as programme spending rose during the 1990s, both as a result of the economic downturn leading to larger social security spending and the consequences of population ageing, this has led to a severe squeeze on spending, which may be leading to allocative inefficiencies. Furthermore, the constraints of the rules have led some canton to shift expenditure off-budget and increasingly resort to non-tax revenue. This serves to reduce the transparency of budgetary reporting, which is already murky with respect to social security and health spending and only weakly constrained by a recommendation to use a common reporting standard. On the other hand, no investment insufficiency has arisen because debt brakes have usually differentiated between current expenses and investment.

The experience of Switzerland highlights the fact that certain institutional features, such as direct democracy and tax competition can help constrain the size of the public sector and obviate the need for tax rules. It also shows that appropriate borrowing and debt rules can enhance fiscal policy even where there is financial market oversight: cantons with stronger debt brakes have experienced a slower growth of expenditure than those with weaker brakes. Nevertheless, such rules need to be flexible with respect to cyclical shocks a significant minority of cantons now allow a correction with respect to the business cycle and forward looking if they are to deal effectively with spending pressures stemming from ageing and demand driven growth of entitlement spending.

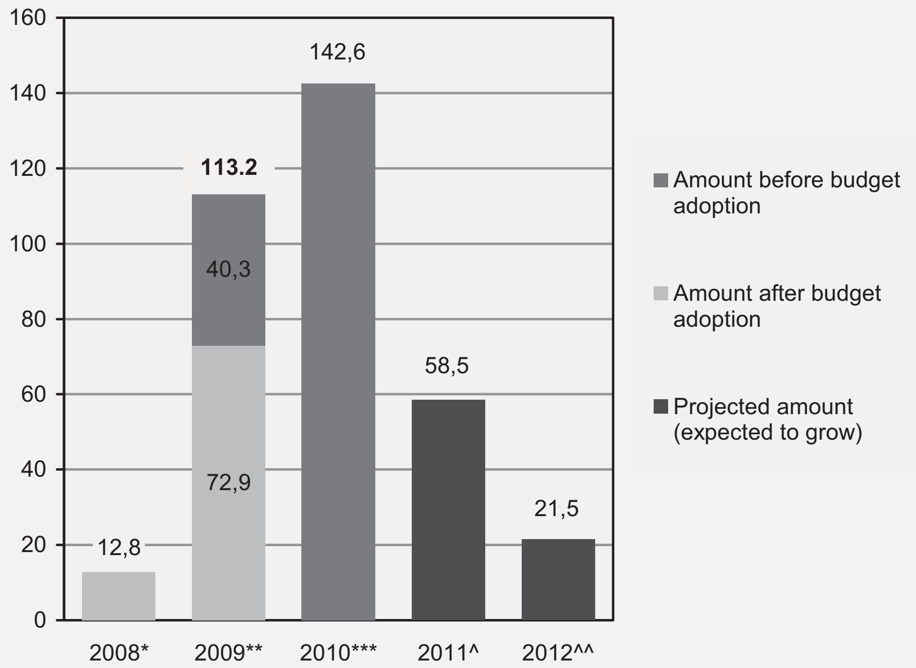
Source : Sutherland, Price, Joumard (2006)

Fiscal rules can help central and SCGs address stability concerns, but they can also suffer from side-effects and trade-offs such as pro-cyclicality, inefficiency or fiscal gimmickry. The recent global financial crisis has clearly shown this, as US States for instance were constitutionally obliged to balance their budgets, which amplified the effects of the crisis as State governments were forced to reduce employment, raise taxes, and sometimes reduce public service delivery (Box 8). In other countries, such scenarios could be avoided as the fiscal rules could be temporarily suspended (Austria, Italy). Efficiency may also be impaired as SCGs lose the ability to smooth consumption over time, and may reduce their level of investment, as capital spending is easier to reduce than current expenditures in the short run. Golden rules have the opposite effect, by leaving capital expenditures outside the rules' frame. SCGs may also appeal to fiscal gimmickry to try to circumvent the rules. Tax and expenditures limits seem to be frequently overcome by the creation of "special districts" that are not covered by the rule, and tax limitations might be circumvented by rising user charges and service fees.

Box 2.8. American states, balanced budget rules and fiscal packages during the global financial crisis

In the United States, 49 states have balanced budget rules enshrined in their constitutions. Any reduction in revenues must therefore be compensated by an equivalent reduction in spending. The crisis has considerably reduced states' revenues, and state budget gaps (i.e. difference between desired spending and projected revenues) have reached unprecedented levels (Box Figure 2.5). As lawmakers prepared their 2009-2010 budgets in July 2009 (FY 2010 budgets), they faced a cumulated gap of over $142 billion. These gaps, though shrinking rapidly, are projected to last at least until FY 2012, as sub-central tax revenues usually take longer to recover in the United States than GDP growth.

Box Figure 2.5. State budget gaps;
FY 2011–FY 2012 (projected, in bn $)



Source : NCSL.

* 20 states reported budget gaps after the adoption of the budget (includes Puerto Rico),

** 44 states reported budget gaps after the adoption of the budget (includes Puerto Rico). The ex-post budget gap was much larger than the budget gap estimated at the time of budget adoption,

*** 46 states report budget gaps at the adoption of the budget (includes Puerto Rico). Ex-post gaps are expected to be larger,

^ 31 states and Puerto Rico forecast FY 2011 gaps, the amount for FY 2011 indicates the 24 states that have provided estimations,

^^ 15 states forecast FY 2012 gaps, the amount for FY 2012 indicates the 9 states that have provided estimations.

The difference between the amounts before budget adoption and the amounts after budget adoption show that no matter how pessimistic revenue forecasts have been, actual collections came in even lower. In FY 2010 to 2012, the fiscal gaps after budget adoption are also expected to be larger than those estimated in the budget.

Because of the balanced budget rules, sub-central governments had to take measures to balance their FY 2010 budgets. Given the weight of sub-central governments in the American economy (they represent 20% of GDP, 38% of general government revenues, 45% of general government spending, and 88% of public investment), these measures ran the risk of amplifying the effects of the crisis. These measures include: spending cuts (across the board cuts, education, hiring and salary freezes, layoffs and early retirement, health care, etc.), raising taxes, increasing fees, etc. For a detailed state by state description of the measures taken to balance FY 2010 budgets, see: http://www.ncsl.org/?tabid=17255.

In February 2009, the Federal administration voted the American Recovery and Reinvestment Act (ARRA). One of the several objectives of this plan was to stabilize state and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases (www.recovery.org). Out of the $787 billion of the stimulus plan, $286 billion affected sub-central governments, either by substituting their expenses (as increased federal participation in Medicaid), or by directly providing stabilization funds. In the FY 2010, these funds have helped offset some of the planned spending reductions, and covered about 40% of the states' budget gaps. It is too early to evaluate whether the stimulus plan reached all its objectives, but according to some experts, it did help preserving existing jobs (Hurley and Tubbesing, 2009). Yet, the situation of the states is still worrying, as the lagged effect of the crisis will cause further budget gaps in FY 2011 and 2012 (Figure 2.1), while they will no longer be able to count on the ARRA funds to bridge these gaps.

These problems are dealt with in different ways, but dealing with different trade-offs and side-effects usually implies the adoption of a multiple set of rules, with some rules created to reduce the side-effects of others. For instance, multi-annual budgets are sometimes used to smooth out cyclical effects, upper limits on tax rates are used to prevent a ratchet effect on spending from a borrowing constraint, and increased information requirement and monitoring may help reducing fiscal gimmickry.

2.6 Promoting efficiency and effectiveness

The growing spending power of SCGs increases the importance of the issue of efficiency and effectiveness for policy makers. Countries have adopted various approaches to generating the competitive pressures and the synergistic opportunities that might enhance efficiency of local public spending. These include in particular, inter-municipal mergers and collaboration, the use of market mechanisms, and the implementation of performance indicators systems.

a) Inter-municipal mergers and collaboration

In theory, inter-municipal mergers and collaboration are warranted under several circumstances including economies of scale, standardization of services, strategic alliances, and financial constraints. However, several empirical studies have shown that the scope for economies of scale from mergers is not so important, and these imply high transition costs (in particular, it is very difficult to actually reduce personnel after a merger). Cooperation might therefore be a more viable alternative, and is very widely developed. In Finland for example, cooperation has been used by municipalities for many years (OECD, 2006).

Denmark has a large experience in cooperative arrangements, with the average municipality participating in approximately 30 such arrangements. Often, larger municipalities act as a supplier and smaller ones act as a purchaser of services. The Danish Commission on Structural Reform found that cooperation can help municipalities gain economies of scale and access a greater number of services, but they also found that cooperation can diminish the tailoring of services to local needs, reduce citizen influence, and make responsibility less clear. Interestingly, mergers rather than cooperative arrangements seem to be preferred by the central government in Denmark, who has recently imposed a merging policy, where each municipality was allowed to choose with whom to merge, as long as they reached a threshold size of 20,000 inhabitants. This reduced the number of municipalities from 271 to 98. At the same time, Denmark created 5 regions which are mainly responsible for health services.

But this type of obligation to merge is very exceptional within OECD countries, where most of the countries do not have an explicit merger policy. Some countries, such as France or Austria even have some disincentive to merge (France encourages cooperation, and Austria just eliminated an equalisation benefit that used to benefit municipalities which reached a threshold of 5,000 inhabitants). The majority of other countries have a voluntary policy and neither encourages nor discourages mergers.

b) Market mechanisms

Market mechanisms constitute another strategy for sub-central governments to improve efficiency and effectiveness. Market mechanisms refer to the set of rules and institutions of a market economy as applied to the public sector (Blöchliger, 2008). These can be supply-side measures, such as outsourcing, private provision, and competition, or demand-side measures, such as “user choice”, vouchers or other forms of performance related funding. The purpose of market mechanisms is to take advantage of the resource allocation efficiencies of the private market in providing public services. Indeed, market mechanisms can increase the efficiency of public service delivery in three ways: improving productive efficiency by lowering costs without compromising quality; increasing resource allocation and welfare by increasing service providers' responsiveness to consumers' tastes and preferences; and improving budget management efficiency by making the costs of providing the services clearer. Market mechanisms are widely used in education, hospitals, public transport, nursing homes, childcare, and waste collection, which are to a large extent under the responsibility SCGs in most OECD countries.

Market mechanisms can be divided into three broad categories, each reflecting the properties of a market economy: private provision and contracting out (public and private partnerships, outsourcing, tendering, etc.), user choice and competition (letting users choose increases pressure on providers to deliver the desired good), and price signals in funding (extent to which public funding reflects actual service utilisation and/or performance).

An OECD index measuring the reliance on market mechanisms can be used for international comparisons. This index is divided in sub-indexes, which reveal that there is substantial diversity in the use of market mechanisms both across countries and across types of public services[14]. For example, private ownership and contracting seems very efficient in Sweden, Australia and Belgium (Flemish part) and less so in Italy, Switzerland and Mexico. User choice is also subject to great variations across countries. It is quite common in childcare and the hospital sector, while it is generally more restricted in primary and secondary education, reflecting the traditional system where parents are assigned a school where they reside. The third sub-index, price signals in funding shows the least variation across countries, and the smallest values, pointing at relatively weak use of this mechanism (within this sub-category, we can distinguish between user fees, which are widely used, and constitute an important revenue source for SCGs, and vouchers and other use-related funding[15], which are still very seldom used).

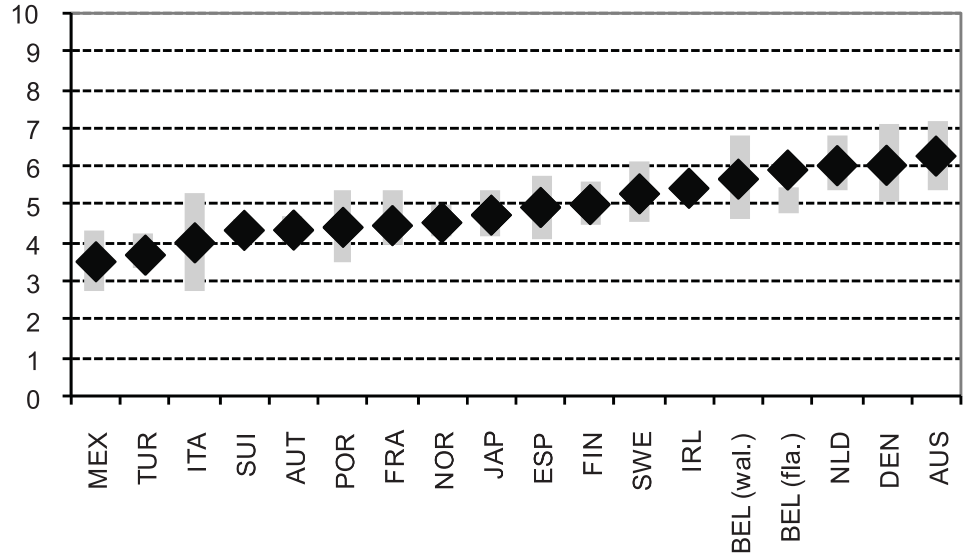
A composite index (summary indicator) measuring the use of market mechanisms can be used to evaluate the scope of each of these arrangements in OECD countries. Figure 2.6 indicates that the composite indicator shows little

[14] See Blöchliger (2008) for the precise values of each sub-index in each country.

[15] Pure "voucher" systems where consumers would receive a lump sum from government do not exist, but "use-related funding", where the government pays the service provider according to a use indicator is becoming more common. Examples include schools funded according to the number of pupils, or nursing homes funded by the number of residents Blöchliger (2008).

variation across countries. Indeed, it appears that countries often compensate low values for one service with higher values for another. The index shows high values (i.e. more efficient market arrangements in public service provision) for Australia, Denmark and the Netherlands, and low values for Mexico, Turkey and Italy.

Figure 2.6. Summary indicator: use of market mechanisms in public service provision (Additive aggregation)



Note: Values scaled between 0 and 10, with a higher value representing more efficient market arrangements in public service provision. For technical details on indicator construction, see the annex of OECD (WP 2008/6).

Source: OECD (WP 2008/6)

If market mechanisms can improve public service efficiency, by introducing competition, by increase user choice or by relying on price signals in funding arrangements, they can also have some drawbacks. Indeed, a wide use of market mechanisms can run against universal policy access objective, with undesirable social and geographical effects. User fees, for instance, might exclude poorer users from public services (hospitals, schools, universities, transportation, etc.). User choice can be a problem if it leads to screening of users by service providers, and contracting out could have negative effect on service coverage.

These drawbacks can be addressed with a set of policy tools, such as setting minimum standards, obliging providers to accept all users, lowering fees for users in need, or giving specific population groups a direct income support to compensate for higher user cost. This can lead to the intervention of central governments, which might wish to make sure that SCGs make good use of economies of scale and scope, while complying with nationally set objectives. Central governments can for instance use earmarked grants or other equalisation systems to allow all SCGs to reach given standard, but without compelling them, or they can set national standards and requirements for service delivery. Finally, central governments can just provide information and benchmarking about the performance of service delivery in other SCGs.

c) Performance indicators

The third tool we have mentioned to promote efficiency is the use of performance indicators or "indicator systems". Indicator systems refer to the systematic collection of information to measure and monitor the activities of government Mizell (2008). The use of this type of system has greatly increased during the 1980's and 1990's, but analysis usually focuses on horizontal use of performance indicators by central or SCGs, to monitor their own performance. In this section, we examine how performance indicators can also be used by central governments to monitor public service delivery by lower levels of government, and to put pressure towards increased efficiency and effectiveness at sub-national level.

Indeed, performance indicators can increase efficiency and effectiveness at sub-national level, first, by increasing available knowledge and reducing information asymmetries between levels of government. This on the one hand, allows the central government to monitor sub-national activities, making sure that national objectives are achieved, and on the other hand, central government can act as a node in a network of SCGs, retransmitting the relevant information to other local governments, in order to disseminate best practices, or provide national benchmarks. Second, the use of performance indicators encourages performance improvements, by altering incentives faced by SCGs. Indeed, indicators can be associated with targets, or provide information to citizens which will then hold their local policy makers accountable for performance.

Performance indicators can serve several specific objectives: allocation of resources, control or resources, evaluation of quality, cost, and coverage, transparency and communication with citizen stakeholders, promoting efficiency, etc. In most countries, benchmarking and learning from good practice are the main goals of the indicators system. Performance indicators are a key instrument in relations across levels of government. Indeed, on the one hand, they reduce asymmetries of information, both vertically, between SCGs and central governments, and horizontally, among different SCGs. And on the other hand, they can be used by central governments to set targets to SCGs, and monitor their performance. But this last point is delicate, as using indicators should not be perceived as an extension of central control. It is therefore very important to involve SCGs in the construction of indicators systems, or else SCGs might comply with the reporting constraint, but not use the information produced by the indicators to actually improve their performance. Building indicator systems should therefore reinforce intergovernmental collaboration. Both levels of government may be motivated to collaborate if they perceive it will lead to new or better information for enhancing service delivery and/or if they can share the additional resources which result from efficiency gains (Mizell, 2008).

A good example of multi-level government collaboration in the building of an indicators system is the creation of KOSTRA in Norway. This system is described in Box 2.9 below. In practice, responses to an OECD questionnaire suggest that the link between performance indicators and national decision making is relatively weak, and the use of explicit targets very rare (only used in Finland and Berlin, Germany). The impact of indicators use is rather indirect, through the higher quality of information available for policy decisions, both at central and local levels (Mizell, 2008).

Box 2.9. KOSTRA - Data reporting and information system in Norway

KOSTRA is Norway's information system for conveying data from the municipalities to the central government, between municipalities, and to the public. Launched for all municipalities in 2002, the system transformed the collection, processing, and dissemination of statistical information from local governments. Emphasis is placed on electronic transmission of data by municipalities to the central government. The latter adds value by combining municipal data and producing key indicators on financial figures, productivity, coverage rates, and priorities. At the municipal level there are about 40 key indicators and an additional 1 000 indicators covering 16 service areas.

The introduction of KOSTRA benefited both the central and sub-central governments. At the central level, the system rationalised data collection and processing, contributed to uniform standards thereby enhancing the comparability of municipalities and service sectors, helped the central government to determine if municipalities are complying with national standards and regulations, and facilitated a common assessment of the local economic situation which is used as the basis of a parliamentary discussion on the transfer of resources to municipalities. For the municipalities, KOSTRA lessened the administrative burden of reporting. It also provided a tool for internal planning, budgeting, and communication at the local level. In addition, it facilitated the sharing of knowledge between municipalities which are able to use indicators for the purpose of benchmarking performance.

While KOSTRA has brought benefits, there are limitations in the current system. First, the large amount of data collected makes ensuring quality challenging. Second, there is a tendency for the central government to request more and more data, causing both the administrative burden and the costs of data collection to rise in municipalities. Municipalities also receive much more data than in the past.

Overall, KOSTRA has been perceived as a very successful information system with potential for further refinement. Looking forward, focus is being placed on collecting data regarding quality of public services and developing indicators of quality. "Soft data" collected outside of KOSTRA (test scores, reading proficiency and user satisfaction for various service, etc.) are gradually being used in combination with data from the KOSTRA system. This will permit policy makers and citizens to assess outcomes as well as outputs.

Sources: OECD (2006), Statistics Norway (2002), "KOSTRA" online at http://www.ssb.no/english/subjects/00/00/20/kostra_en

If using a system of performance indicators can have positive effects on efficiency, its implementation poses some challenges. The first challenge to overcome is capacity building. Indeed, constructing and operating a system of indicators requires experience in defining good indicators, in assessing the quality of the data, the needs that should be covered, etc. Second, using indicator systems is costly. Costs occur in a direct form, by the necessary investments in information systems, training, communication, etc., but also in a more indirect way, through an increased administrative burden, which might be disproportionately high for small municipalities. This point can be tempered by coordinating information needs and reducing redundant requests, as well as carefully selecting the indicators, in order to reduce their number. Another type of possible cost is due to the risks of strategic behaviour (short-termism) or prioritization of resources to influence the measures of the indicators. The last challenge is measurement and data quality concerns. Indeed, public sector's outputs and performance are very difficult to measure. Besides, there is a trade-off between timeliness and quality of data, as using timely data can enhance the relevance of indicators for decision making, but it may be harder to review and validate recent data. Auditing can improve data quality, but may delay its availability.

2.7 Brief panorama of fiscal federalism reform agenda in OECD unitary countries

The OECD Network on Fiscal Relations across Levels of Government is currently carrying out a study on the political economy of fiscal federalism reforms. Some preliminary findings show that there are a number of exogenous elements that influence the chances of a reform going through. For example, a strong leadership backed by a clear electoral mandate are obvious elements that facilitate reforms going through. The role of crises is more ambiguous. Indeed, on the one hand, they highlight the limits of the existing model and the need for reform. But on the other hand, reforms are costly and are therefore more difficult to implement in times of stringent financial resources (preliminary findings of the above mentioned OECD study show that these are never financially neutral for the CG, who at the very least has to put up money to compensate losers).

Following the global financial crisis and stimulus measures, both central and sub-central governments face large fiscal imbalances which will have to be addressed. This process will necessarily imply reforms in intergovernmental relations, as both levels of government will seek efficiency gains (through territorial reorganisation for example), and increased revenues. Coordinating central and sub-central fiscal consolidations plans will be a challenge in the years to come, as both levels of government will be fighting to raise revenues (competing for fiscal resources or lobbying for increased grants), while trying to shift spending responsibilities to other levels of government. But if the global financial crisis highlights the need to reform, it also makes it more difficult, as there is less money available to compensate losers, and it's more difficult for CGs to take measures that may affect SCGs' finances negatively. In Finland for example, the reform of the grants system was scaled down, as the government decided not to change the allocation formula in order not to increase the financial difficulties of SCGs. In France, the global financial crisis certainly hastened the repeal of the business tax (*taxe profesionnelle*). As this tax accounted for about 80% of the revenues of the *departments*, this measure instigated the rethinking of the whole of the financing scheme of SCGs in France. This thus revived the debate on territorial organisation, the overlapping roles and responsibilities of the different layers of government and between the deconcentrated institutions (the *Préfets*), and the decentralised structures, etc. The debate is ongoing, and no decision has been taken yet.

The study also identified a number of elements that help reforms go through and can be used by policy makers to design the reform package and process. Indeed, in all public administration reforms, there are different stakeholders with diverging interests, and any reform produces winners and losers.[16] For the reform to go through there must be more potential winners supporting the reform than losers blocking it. There are several ways of achieving this, and in most cases, successful reforms combine several of these elements.[17] The most direct and frequently used instrument is to give financial compensations to the losers of the reform, so that they are indifferent to the reform. But frequently, reforms are blocked even though the expected number of winners is larger than the expected number of losers, only because of the uncertainty of individuals about whether they will be in the winners or losers pool. In the case of municipal mergers for example, some politicians and local civil servants may lose their jobs, but nobody can tell ex-ante to which group they will belong. So even if those keeping their jobs are promised to be better off, a majority of individuals may oppose the reform, because of the uncertainty about their personal outcome. To avoid such scenarios, governments can provide explicit guarantees to stakeholders, that there will be no losers (at least during a transitory period). For example, guaranteeing that there will be no layoffs in the five years following a municipal merger, or that local taxes will not be allowed to increase in the years following the reform, etc. Finally, bundling several reforms together can be a way to generate support for a reform package, as individual stakeholders may profit from some of the reform elements, while losing from other, thus being indifferent to the package. Reform bundling is very frequent in fiscal federalism reforms: most of the time, territorial organisation reforms (such as municipal mergers) are combined with a redefinition of the roles and responsibilities of each level of government, and with a redesign of the revenue mix of SCGs. This appears clearly in Table 2.6 below, which presents a brief summary of some fiscal federalism reforms carried out recently in unitary countries. The recent Local Government Reform in Denmark is a good illustration of how these different elements can be successfully combined. Finland on the contrary appears as an exception, as it has implemented the three types of reforms sequentially, without bundling them or using cross-compensation mechanisms.

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[16] For a broader discussion on the political economy of public administration reforms, see: Charbit, C., Vammalle, C. (2010), "Modernising Government", in Making Reform Happen: Lessons for the Future, OECD Publishing, Paris.

[17] By successful, we do not mean that the reform has achieved its objectives, but only that it went through all the phases and was actually implemented.

*Table 2.6. Preliminary summary of recent reforms and current proposals in some OECD unitary countries**

Type of reform **Country**	**Territorial organisation**	**Allocation of roles and responsibilities**	**Financing of SCGs**
Chile	December 2006: creation of two new regions. As of January 2007, regional planning responsibilities were transferred to regional governments; further responsibilities will soon be devolved to regional governments. The implementation of some social programs has recently been transferred to municipal governments. Just approved a constitutional reform on regional governments which includes the direct election of regional councils		
Denmark	• Creation of 5 regions, reduction of the number of municipalities from 271 to 98 by voluntary mergers • Reallocation of roles and responsibilities between the central government, the newly created regions (mainly in charge of health services) and the municipalities • Reform of the funding of municipalities and equalization system		
Finland	PARAS reform (2007): financial incentives for voluntary municipal mergers, with possibility of choosing municipal cooperation. The number of municipalities was reduced from 436 in 2000 to 332 in 2009.	ALKU administrative reform project (2008): transfers a number of responsibilities to the Regional Councils	Reform of the grants system (2009): the three main grants for municipalities (education, health and general grant from Ministry of Finance) were merged into a single general purpose grant managed by the Ministry of Finance. In spite of an initial plan to change the allocation formula of the grants, this was finally not implemented as a consequence of the global financial crisis (to prevent municipalities from suffering further financial losses).
France	Local government reform currently debated (*Réforme des collectivités territoriales*): a single elected representative (*conseiller territorial*) would replace the representatives of the *régions* and the *départments*; creation of metropolis and metropolitan poles; consolidation of municipal cooperation bodies into new communes (*communes nouvelles*) and grouping of regions and departments; finishing the inter-communality map, review law on the assignation of responsibilities and competencies. With the recent repeal of the business tax (*Tax Profesionnelle*), discussions are under way on alternative sources of financing for the *départements*, for whom this tax represented about 80% of the revenues.		
Greece	Kalikratis reforms: prior to the present Greek crisis, project of municipal mergers to improve efficiency.		
Japan	Financial incentives for municipal mergers reduced the number of municipalities from 3,232 in 1999 to 1,795 in 2008.		"Trinity Reforms" since 2002: transfer of tax sources from the CG to SCGs, reconsideration of the equalization tax and decrease of a national grant.

(continues on the next page)

Type of reform / Country	Territorial organisation	Allocation of roles and responsibilities	Financing of SCGs
Korea	Programs to support voluntary integration of local governments	In July 2008, the government announced a mid-term plan to devolve considerable powers from deconcentrated central government special agencies to local governments, but the reaction to the crisis has shown that policy making and implementation is still extremely centralized in Korea.	Introduction of local taxes in 2010: Local Consumption tax and a Local Income tax.
Luxembourg	A comprehensive reform debate on territorial and administrative reform is underway. Proposals currently debated include the abolition of cantons and districts, the introduction of public regional coordinating agencies (comparable to French Prefectures), and the reform of inter-municipal structures and responsibilities		
Poland		A package of legislative proposals launched by the government in May 2008 include shifting responsibilities for a broad range of policy issues from the CG to SCGs.	
Portugal			Reform of the Local Finance Act in January 2007: measures to expand municipal competences (notably via the creation of a Municipal Social Fund – FSM – an earmarked grant to finance specific expenditure in education, health and social policy), and to increase municipal revenues (via the possibility for municipalities to receive up to 5% of the national income tax). Increase equalization transfers
Slovenia	Regionalization project discussed at the moment: creation of a new administrative regional level in charge of regional development.		
Spain			Reform of the financing of Autonomous Communities (AC)(2010): increases financing of the AC, and in particular, the share of taxes in AC's revenues.
Sweden	Asymmetric decentralization: regionalization reforms, merging of existing counties, and reallocation of competencies to the regional level (such as regional development, special planning, public transport, etc.)		

* This table is not an exhaustive list of all the reforms carried out.

2.8 Conclusions

One observes a wide array of multi-level government systems in the OECD because of differences across countries in institutions, the size of government, the tasks assigned the SCGs, and financing possibilities. Multi-level governance in the OECD thus involves a somewhat more complex assignment of tasks, and one with more constraints, than the classic assignment of expenditure and revenue functions of Oates. The OECD assignment is perhaps closer in nature to Olson's theory of "fiscal equivalence," albeit a fiscal equivalence with constraints that lead in many instances to an overlapping of functions. Some of the deviations of countries from the classic assignment can also be explained by the use of more than one policy instrument (e.g. local income taxes in combination with equalizing grants) that effectively turn an inefficient policy into an efficient one (Goodspeed, 1995).

The recent global financial crisis has shaken some of the traditional principles of fiscal federalism, and highlighted the need for coordination between levels of government. This was true during the crisis, but will be all the more the case in the years to come, when all government levels will seek to consolidate their budgets, as deficits and debt levels have risen to unprecedented levels. Coordinating fiscal consolidation efforts to avoid a "war of attrition" between levels of government about who will bear the cost of the consolidation is probably one of the next greatest challenges. Achieving fiscal consolidation will require efficiency enhancing reforms of fiscal federalism in a wide range of OECD countries. But if the global financial crisis may have highlighted the need for reform, it may also make structural reforms more difficult, as there is less money to compensate losers.

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Chapter 3

Local government in Denmark, Norway and Sweden

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3.1 Local government in Denmark

Jens Blom-Hansen

3.1.1 Introduction

Compared to the other Nordic countries Denmark is a geographically small country where nature poses relatively few barriers to administrative districting and where the population is relatively evenly distributed across the country. These preconditions make the arrangement – and rearrangement – of the local government system a comparatively modest challenge. In addition, the Danish constitution provides no serious obstacles for central government decision-makers bent on reforming local governments. Article 82 of the constitution states that municipalities have a right to manage their affairs autonomously, but it quickly adds that this is to take place under the supervision of the state. The constitution prevents the central government from abolishing the local government system. But it provides no protection against changes of the size of local authorities, their political system, functions, decision-making procedures, election system, income sources, or administrative organisation. In practice, the central government has a relatively free hand.

Seen from the perspective of local governments, the only constitutional safeguard mechanism is that changes must be done by legislation and thus be acceptable to the Danish parliament, *Folketinget*. But history shows that this is a weak shield. In the post World War II period, the central government has shown no restraint in using its free hand, and securing a parliamentary majority has not proven impossible. In both 1970 and 2007 large-scale local government reforms were carried through that fundamentally changed Danish local government. These are explained later in the chapter.

While Danish local government has experienced fundamental changes across a relatively short span of time there are, however, also some persistent traits. Since the era of absolutist royal rule, which ended with the introduction of a democratic constitution in 1849, Denmark has had a three-tiered public sector. At the central level, the government has been responsible for regulatory functions and selected services such as the military and higher education. At the regional level, counties or regions have been entrusted with functions requiring a relative large population base such as hospitals. At the local level, municipalities have been responsible for welfare services and schools. Compared to most other countries, the distribution of functions across tiers has been highly skewed in favour of the local and regional level. In addition, Danish local and regional governments have traditionally enjoyed independent taxation rights to a higher extent than most countries. However, this picture has changed in recent years. After the 2007 reform municipalities are responsible for more functions than ever, but local taxation is less autonomous. The balance that all local government systems must find between local self-government and central control policies has been tilted in the direction of the latter.

This chapter provides an introduction to the Danish local government system and the challenges it faces today. The following section begins with a brief overview of the history of Danish municipalities and regions, but quickly moves on to a description of the organisation of the present system, including its political-administrative organisation, functions and finances. In the third section the effects of the 2007 local government reform are discussed. This was a comprehensive reform that reduced the number of municipalities by two thirds and led to a new distribution of tasks across tiers. The fourth section provides an evaluation of the present system. In the fifth and final section the problem of macroeconomic management is taken up. The comparatively large local government sector means that using public expenditure and taxation as macroeconomic control instruments must include the local government sector. This is done in a unique coordination system known as the budgetary cooperation between central and local government.

3.1.2 The Danish local government system[1]

The history of the system

The foundation of the present Danish local government system dates back to the era of absolutist royal rule, which lasted from 1660 until 1849. In the 1830s the King established a new local government system. In the urban areas Denmark's around 80 market towns were entrusted with all local functions. In the rural areas a two-tiered structure was established: approximately 1,100 parish municipalities would handle basic local functions such as primary education and social security, while county councils would be responsible for tasks that required a larger population basis such as hospital services.

This structure was kept more or less intact until 1970 when three sets of reforms led to a complete overhaul of the local government system (Ingvartsen and Mikkelsen 1991). First, a dramatic geographical consolidation was initiated. More than 1,000 parish municipalities and 80 market towns were amalgamated into 275 new municipalities; the 25 counties were merged into 14; and the amalgamations abolished the old distinction between rural and urban local government systems. From then on, a new nation-wide two-tiered system was introduced: counties were responsible for regional tasks, the new municipalities for local tasks. Only Copenhagen was left untouched and thus functioned as both county and municipality in the new system. Second, following the amalgamations, a reform of local governments' functions was carried through over the next 10–20 years. New tasks were transferred to local governments from the central government, and increased autonomy was introduced in the welfare areas that municipalities and counties already administered. Third, a financial reform was implemented. In a series of separate reforms, matching grants in a number of areas were gradually transformed into one general block grant which together with the local income tax became the main local income sources. In addition, an inter-municipal equalization system was established. These reforms strengthened local autonomy, but also stressed their role as providers of national services.

However, this reform only lasted to the end of the millennium. In 2007 a new sweeping reform was enacted. Again, geographical consolidation was a major part. The 271[2] municipalities were now amalgamated into 98 large municipalities, and the 14 counties into five new regions. This time, Copenhagen was included: it was split up into a regional part that was transferred to the new

[1] This sections draws on Blom-Hansen & Heeager (2010).

[2] The 1970 reform created 275 municipalities, but in 2003 the five municipalities on the island of Bornholm were amalgamated into one, leaving 271 municipalities in 2006.

Capital Region and a municipal part that continued as one of the new municipalities. This part of the reform was remarkable because Copenhagen had previously succeeded in resisting reform attempts from above. But this time the break-up of the county level was too fundamental for Copenhagen to resist it. This was probably eased by the fact that Copenhagen – and all its neighbouring municipalities – were not subjected to any amalgamations. Figure 3.1 shows the local map of Denmark after the 2007 reform.

Figure 3.1. Map of Denmark's 98 municipalities

Source: Ministry of Interior and Health

The 2007 reform also included an overhaul of functions. Apart from health care, the old counties were stripped of almost all functions, which were divided between the central government and the new large municipalities. Finally, the

2007 reform was also a financial reform. The regions did not inherit the old counties' taxation rights, but were to be financed by central government grants. At the municipal level, income taxation is still the cornerstone of the financial system, but the inter-municipal equalization system was reformed. From now on, rich municipalities have to pay more to poor ones (Blom-Hansen et al. 2006; Mouritzen 2006).

By international standards these reforms are radical, and the question is how such large-scale societal changes are possible? The explanation consists of a complexity of factors. First, the development can be seen as a response to the functional needs of the central government. The rise of the welfare state in the 1960s created a need for professional implementing agencies. Second, there is a large element of path dependency in the development. Local governments have always been responsible for basic welfare services in Denmark. In the 1960s no-one questioned that the Danish welfare state was going to be municipal. This was taken for granted, and alternatives were not seriously considered. The agenda, both in 1970 and 2007, was how to create a local government system that was up to the job. Third, as noted by Page (1991: 97–138), in southern Europe, clientelism blocked local government reforms, while the absence of this type of close central-local government networks in Denmark and the other northern European countries left the central government free to shape local government according to its perceived needs.

Despite the above mentioned facts, the far reaching reform in 2007 is still puzzling. First of all, the need for a reform was on the political agenda for only a few years before action was actually taken, and no-one had seen so radical changes coming. Second, amalgamation would lead to a considerable loss of local power for the Liberal power, one of the government parties, since many mayors in small municipalities belonged to this Party. Finally, municipalities and counties have strong national associations that protect their interests. Local Government Denmark (*Kommunernes Landsforening*), the municipalities' national association, has even been considered a 'fourth branch of government' (Blom-Hansen 2002). The regions' national association, Danish Regions (*Danske Regioner*) (before 2007 the Association of County Councils – *Amtsrådsforeningen*) plays a similar role. The national associations are regularly consulted by the central government as part of the Danish corporatist tradition, and they were wary of amalgamations and reshufflings of functions across tiers. As argued by Christiansen and Klitgaard (2008) the key to understanding the successful reform is probably to a large extent the personal capabilities of the Interior Minister as a reform manager. In order to create a strong reform coalition he effectively presented the municipalities with an offer to accept amalgamations in exchange for taking over substantial new tasks from both the old counties and the central government. This tactic secured support from the municipalities for the reform, but at the cost of the old counties.

The 2007 reform reduced the number of municipalities and regions. The reform amalgamated the previous 271 municipalities into 98 new and larger entities. Although not all municipalities were subjected to amalgamation, it had dramatic consequences for the size of municipalities. As Table 3.1 shows, Denmark has very few small municipalities today. The reform has almost tripled the average size of municipalities. At the regional level, the 2007 reform abolished the 14 counties and established five new regions with populations varying from 0.6 million (North Jutland) to 1.6 million (the Capital region).

Table 3.1. The size of Danish municipalities and regions before and after the 2007 reform

	Municipalities			**Regions**	
	Before the reform (2005) Per cent	After the reform (2007) Per cent		Before the reform (2005) Per cent	After the reform (2007) Per cent
No. of inhabitants:			No. of inhabitants:		
Below 999	-	-	Below 250,000	28.6	-
1,000–5,000	5.9	3.1	250,001–500,000	57.1	-
5,001–10,000	41.7	1.0	500,001–750,000	14.3	20.0
10,001–50,000	46.1	61.2	750,001–1,000,000	-	20.0
50,001–100,000	4.8	28.6	1,000,001–1,500,000	-	40.0
Above 100,000	1.5	6.1	1,500,001–2,000,000	-	20.0
Total no. of municipalities	271	98	Total no. of regions	14	5
Average no. of inhabitants	19,900	55,200	Average no. of inhabitants	344,100	1,089,400

Source: Statistics Denmark.

The organisation of the present local government system

The political system in the municipalities consists of three bodies: a council, a set of standing committees, and a mayor. The council consists of 9–31 members, it is the supreme municipal body, and may be considered the local legislature. Executive power is exercised in a committee system with a division of labour between the mayor and the standing sectoral committees. The mayor is elected by and among the council members on a simple majority basis and is the head of the municipal administration and chairs the council as well as its financial committee. It is an influential post, and the mayor is widely regarded as the leading municipal politician (Berg & Kjær 2005). The members of the standing committees are also elected by and among the council members, but on a proportional basis. The committees are responsible for the day-to-day administration within the various policy sectors. In other words, they are the local executive organs within the various policy areas. The chairmen of the committees are elected by the committees on a simple majority basis. Although the chairmen only have few formal powers, they can be quite powerful since considerable influence is often delegated to them in practice. Consequently, the mayor and the chairmen of the sectoral standing committees together constitute the executive power in the Danish local government system. They are the functional equivalent of the government in the national system. But in contrast to the central level, due to its proportional composition local executive power is normally based on consensus and rests on a broad coalition of parties (Serritzlew et al. 2008).

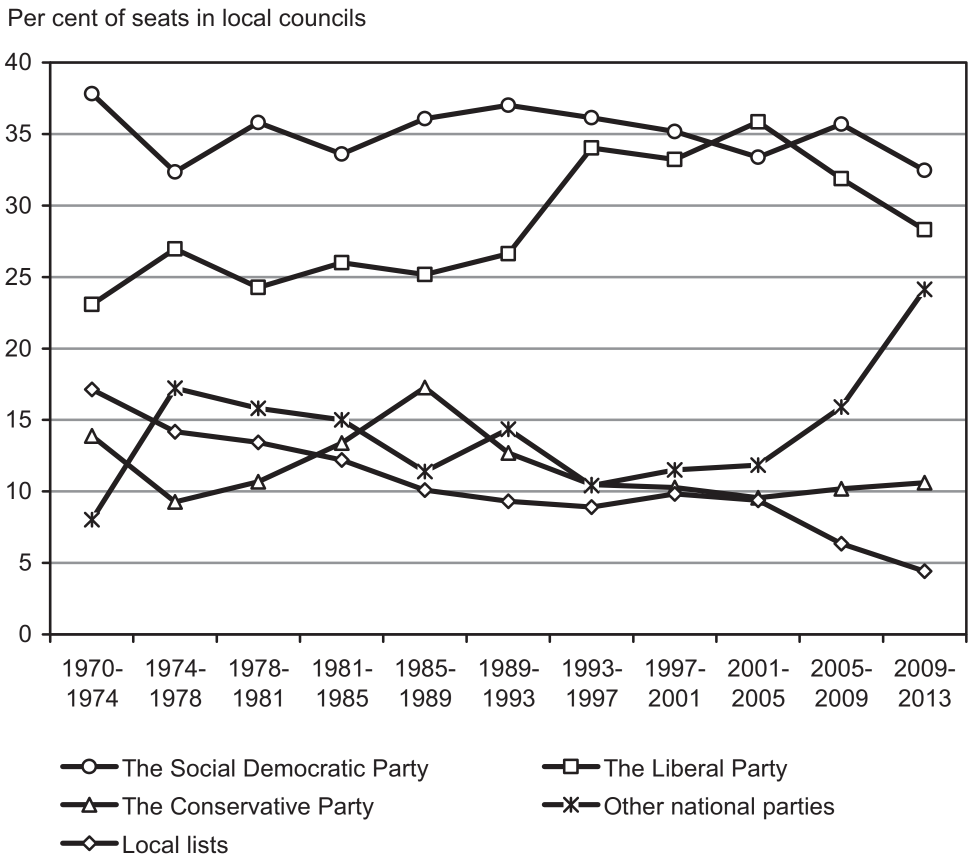
The municipal political system is assisted by a large professional Weberian administration. In formal terms it is a unitary service directed by the mayor, but due to two factors it has strong sectoral traits in practice. First, in substantial matters the administration does not answer to the mayor but to the committees. Second, the administration has traditionally been divided into sectoral departments corresponding to the committee structure. Nowadays this correspondence is often deliberately broken in order to reduce sectorization and in addition a cross-sectoral administrative directorship is often installed between the sectoral departments and the political level (Bækgaard 2008).

At the regional level, the counties had a political system similar to the municipalities' until the 2007 reform, but now there are important differences. The supreme body is the regional council, which has 41 members. There is also a regional chairman, a post that is comparable to the municipal mayor. However, the regions do not have a committee system. They may, but are not obliged to, leave daily administrative matters to an executive committee, but cannot establish standing sectoral committees like the municipalities and the old counties (Krogh 2008).

The election system to municipal and regional councils is proportional like the national system, but much simpler. Elections to municipal and regional councils are held at the same time. At the municipal level, each municipality is one constituency, and the number of seats in the municipal council is divided among the parties and lists by the d'Hondt's method. There are no formal electoral thresholds, but given the relatively small number of council seats there are natural thresholds. For instance, in a council with 25 seats, the natural threshold is approximately four percent of the votes. Since the number of seats in the municipal councils was increased after the 2007 municipal reform, the natural threshold was lowered. This was an advantage for the small parties whose chance of local representation increased. The election system to the regional councils is identical to the municipal system (Elklit 2009).

As in national politics, the proportional election system results in multiparty systems at the local level. Figure 3.2 shows the national result of municipal elections across a 45-year period, i.e. since the 1970 municipal reform. Three large municipal parties, all local branches of national parties, have dominated local politics throughout the period: the Social Democratic Party, the Liberal Party, and the Conservative Party. A varying number of other local branches of national parties are represented in local politics. In the figure, they are grouped together as 'other national parties', since they very rarely obtain more than ten percent of local seats. As the figure shows, their share of local seats has been growing since the 2007 reform, effective for the election period 2005–09. This is partly due the reform which increased the size of municipalities and lowered natural thresholds and thus made it easier for the smaller national parties to run in all municipalities. However, it is also partly due to a remarkable election victory in 2009 for the Socialist People's Party which in this election doubled its share of seats. Finally, the municipal party system includes various local lists, i.e. parties that are not organized on a national basis. As the figure shows, these lists have lost ground since 1970. The amalgamation reform in 2007 accelerated their decline.

Figure 3.2. *Distribution of all seats in municipal councils among political parties and local lists between 1970–2013*



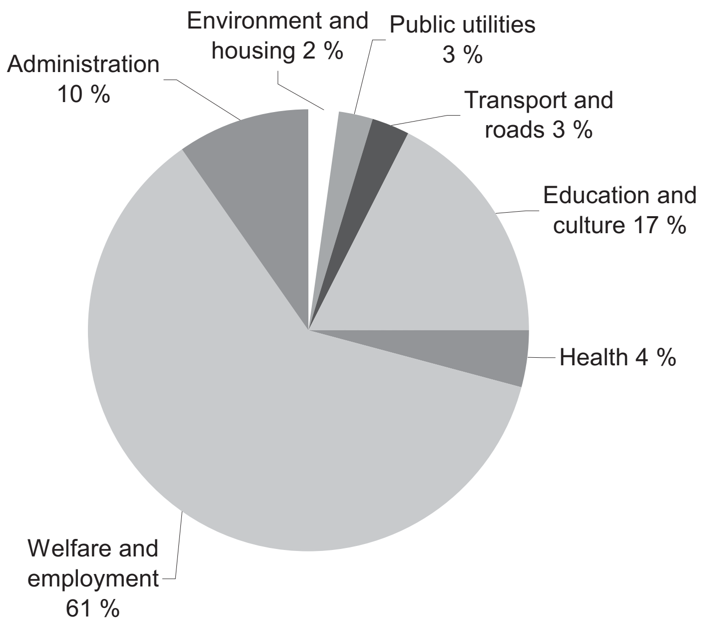
Source: Statistics Denmark

Figure 3.2 shows the national result of local elections, i.e. the average municipal party system. The situation in individual municipalities may, of course, differ considerably from this picture. But over time the municipal party systems have come to resemble the national party system more and more. The 2007 municipal reform caused a further ‘nationalization’ in the sense that local branches of national parties run for office in more municipalities and occupy a larger share of municipal seats than before the reform. Also, local lists occupy fewer seats than before the reform. At the regional level, party systems resemble municipal ones, but an even more pronounced nationalization has taken place (Elklit and Kjær 2007).

The functions of municipalities and regions

The provision of welfare to Danish citizens is decentralized to municipalities and regions to a greater extent than in most countries. The expenditure pattern of the municipalities is shown in Figure 3.3. The most important expenditure area is welfare and employment. This area comprises child care and elderly care, which have always been important functions for Danish municipalities. But it also includes functions which have recently been transferred to the municipal sector. First, the municipal reform in 2007 meant that specialized social services for the physically and mentally handicapped were transferred from the old counties to the municipalities. Second, in 2009 the municipalities took over the full responsibility for unemployment services. Until then, this system had been divided between the central government, which was responsible for insured unemployed persons, and the municipalities, which were responsible for unemployed without insurance.

Figure 3.3. Municipal expenditure functions (budget 2010)



Source: Statistics Denmark

The second most important expenditure area is education and culture. This reflects the fact that Danish primary schools are run by the municipalities (while secondary and tertiary education is a central government responsibility). They have some autonomy to do this, for instance to decide the number, size, and geographical placement of schools, the size of classes, and the weekly number of teaching lessons. But this area is also regulated in considerable detail by laws, administrative decrees, and collective agreements with the Teachers' Union. In addition to schools, this expenditure area also includes public libraries, support to theaters, and leisure activities.

Since the municipalities' functions in the welfare and education areas involve considerable expenditure, efficiency and productivity is an issue of some concern. The central government is keen on encouraging the municipalities to solve their tasks as effectively and productively as possible. This is mostly done through benchmarking analyses and by pointing out municipalities with the "best practice" in selected areas. But evaluating efficiency and productivity in the welfare and education areas is difficult since the municipalities' production in these areas is not easily measured. A good example is provided by the Finance Ministry which in 2010 published an analysis of municipal expenditure for primary schools, child care and elderly care. It was easy for the ministry to point out considerable expenditure differences among the municipalities. These are shown in Table 3.2. But explaining these differences is not straightforward. As the ministry stated "some of these differences are due to different objective conditions, some to different local decisions on service levels, but some differences are also due to the fact that the municipalities are not equally effective in utilizing their resources" (Finance Ministry 2010a: 15; my translation). The only conclusion on efficiency that the ministry drew was to encourage the municipalities to pay attention to factors that may influence productivity and efficiency in these areas: Teachers' working time spent on teaching, size of school classes, size of institutions, and the division of administrative tasks between the institutions and the town hall. However, the ministry wisely refrained from specifying the exact relationship between these factors and expenditure levels.

Table 3.2. Differences in municipal expenditure levels in welfare and education (2008)

	Average of five most expensive municipalities	Average of all municipalities	Average of five least expensive municipalities
Primary schools (annual DKK per pupil)	78,400	60,000	49,300
Child care (annual DKK per 0–10 year old)	57,200	42,300	31,700
Elderly care (annual DKK per +65 year old)	63,600	51,600	40,100

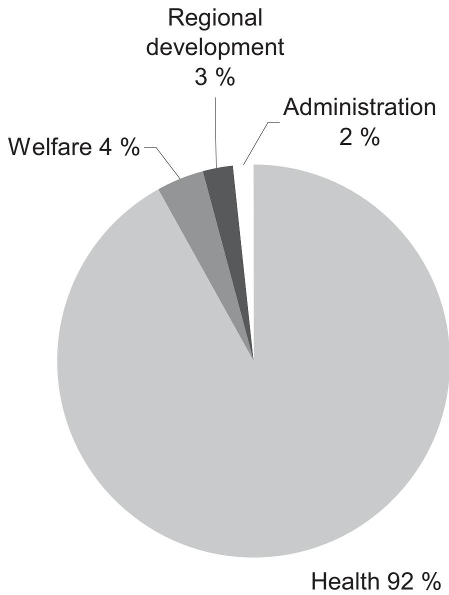
Source: Finance Ministry (2010a).

The remaining municipal functions are minor, at least in monetary terms. First, the municipalities have always had important responsibilities in the utility area. This area has led a quiet life in municipal politics because, financially, they are subjected to a balanced budget rule that requires expenditure to be fully financed by user charges and, organizationally, they have traditionally been left to cross-municipal cooperative ventures. Water supply and sewage disposal are now by law required to be organized as private companies and are thus taken out of the municipal organization. Electricity, garbage collection, and heat supply are organized as either private companies, joint municipal ventures or as ordinary municipal departments.

Second, municipalities have always been responsible for local roads. After the 2007 municipal reform they also took over regional roads. Third, the 2007 reform also gave municipalities some health functions, primarily within health care prevention and rehabilitation therapy. Finally, the municipalities have some functions within the environment, housing and land use planning areas.

At the regional level, the 2007 reform stripped the old counties of almost all their functions, except health care. As is evident from Figure 3.4, health care is by far the most important task for the five new regions. This area comprises a primary and secondary part. The primary health care system offer basic health services and is organized as contracts between the regions and general practitioners, specialists and dentists. General practitioners function as gatekeepers to the secondary health care system which consists of the hospitals which are organised as public institutions under the regions.

Figure 3.4. The regions' expenditure functions (budget 2010)



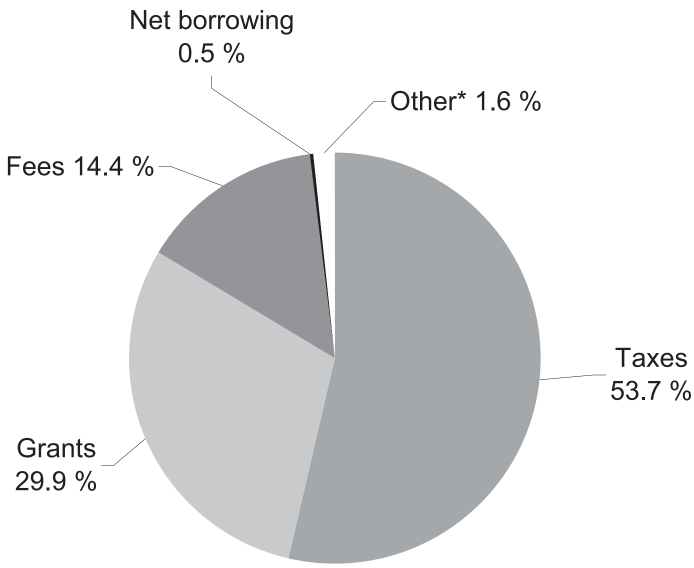
Source: Statistics Denmark

In addition to health care the regions are responsible for running certain institutions for the physically and mentally handicapped, and they also have a coordinating function in relation to regional development.

The finance system of municipalities and regions

The expenditures of municipalities and regions are financed by different income sources, cf. Figures 3.5 and 3.6.

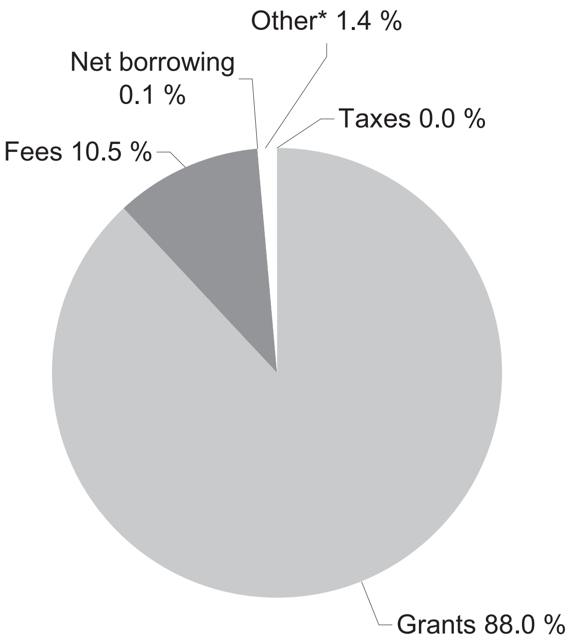
Figure 3.5. The municipal system of finance (budget 2010)



* Other includes sale of capital assets, net interest payment, and use of liquid means.

Source: Statistics Denmark

Figure 3.6. The regions' system of finance (budget 2010)



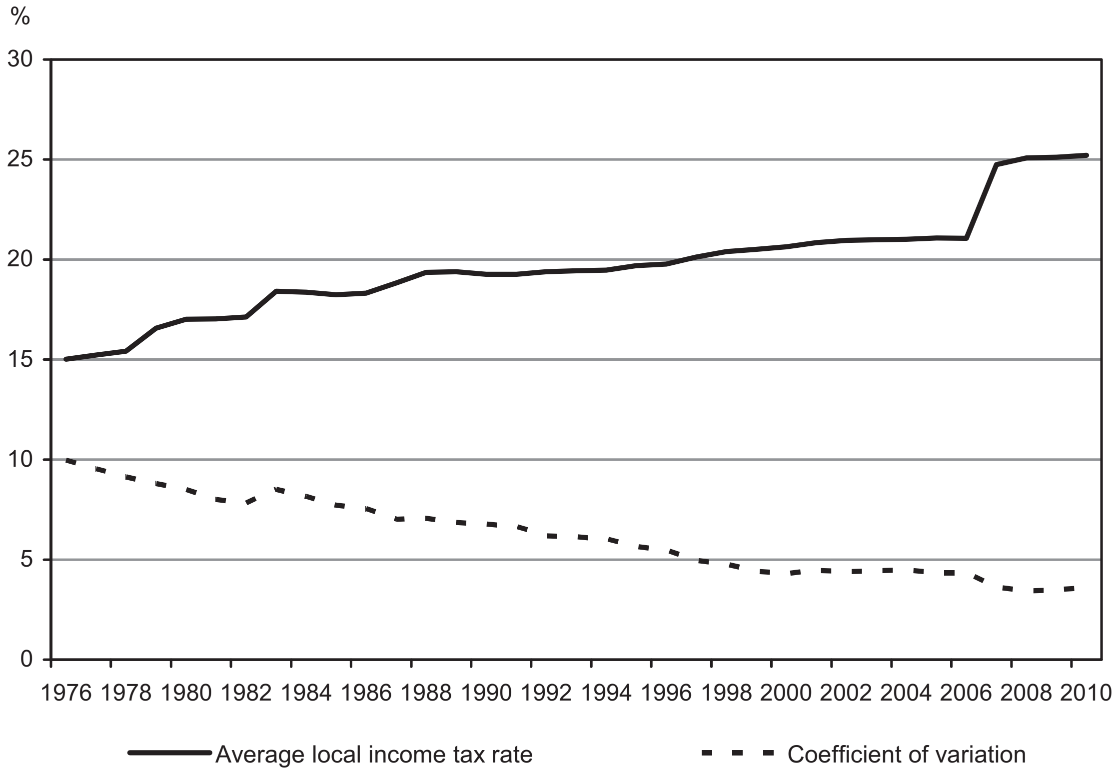
* Other includes sale of capital assets, net interest payment, and use of liquid means.

Source: Statistics Denmark

For the municipalities taxes are the most important source of revenue. The most important one is the local income tax (86 per cent of all tax revenue in 2010). This is levied as a flat rate tax. Formally, municipalities are free to set the rate. But in reality the independent municipal taxation right is constrained by the central government. This is done through the system of annual economic agreements between the central government and the association of local authorities, *Local Government Denmark*. This is a system which the central government uses for macroeconomic control purposes. In practice, the annual agreements set an upper limit for local taxation, cf. below in sections 3.1.4 and 3.1.5. Individual municipalities may adjust their rates up- and downwards, as long as this general limit is kept. In principle this system strikes a balance between central control and local autonomy, but in practice it leads to rigidity over the years. Municipalities are reluctant to lower their tax rate since they fear future tax constraints from the central government. This again means that there is less room to increase tax rates. So over time local taxation is becoming more and more similar across municipalities and in practice Denmark is approaching a system with a local fixed flat rate tax.

In 2010 the average local income tax rate is 25.2. This is the highest ever and the result of a gradual increase in local taxation after the 1970 reform. The development over time is shown in Figure 3.7. The local tax rate has gradually increased from a level of approximately 15 per cent to about 21 percent before the municipal reform in 2007. This development reflects the expansion of the Danish welfare state which, cf. the previous section, is to a high extent a municipal phenomenon. In 2007 municipal taxes increased abruptly by about four percentage point because the reform abolished the old counties' taxation right which was divided between the central government and the municipalities (Juul 2006: 15–21). The dotted line in Figure 3.7 shows the coefficient of variation, a standardized measure of the spread around the mean of the local income tax rate. It shows a down-ward trend over time meaning that the variation in local income taxation is decreasing. Local income tax rates gradually become more and more alike.

Figure 3.7. The average municipal income tax rate in 1976–2010



Source: Statistics Denmark

In addition to income tax, municipalities also levy taxes on property and receive a share of corporate income taxes. But these taxes generate far less revenue (11 and 3 per cent, respectively, of all tax revenue in 2010).

The second most important municipal income source is grants from the central government, cf. Figure 3.5. There are two different types. The first is a set of matching grants. Before the 1970 local government reform Denmark had a bewildering number of matching grants covering almost all types of municipal expenditure. But a series of reforms in the following decades abolished most matching grants. Today they are only used to help finance local transfer payments such as old age pensions, social security and housing benefits.

The second type of central government grant is an unconditional grant known as the ‘general block grant’. This is used for a number of purposes, but common to them all is the fact that the grant comes with no strings attached. The major part of the general block grant is used as an equalization grant that compensates municipalities with high expenditure needs and/or a low tax base. Expenditure needs are calculated as a combination of demographic criteria and socio-economic characteristics. The tax base is calculated as a combination of taxable income and property values. This tax base is used to calculate each municipality's normalised tax revenue from which then is subtracted the municipality's calculated expenditure according to expenditure needs. This results in either a surplus or a deficit depending on the municipality's overall economic situation. The surplus/deficit is then equalized by 58 per cent. In addition to this national equalization system there is an extra system for the municipalities in the Copenhagen area, a special grant system for very poor municipalities, and a number of minor grant schemes to help finance special purposes such as expenditure related to islands or immigrants.

Once equalizing grants have been financed, the remaining part of the general block grant is distributed among the municipalities according to population size. This part of the general block grant is the prime instrument for macroeconomic control of the municipal sector. If the central government wants higher or lower activity in the municipal sector, adjustments of the general block grants is normally the instrument. It is also adjusted when functions are transferred across tiers in the public sector or if new laws or administrative decrees impose economic burdens on municipalities. The system means that the central government must finance new municipal expenditure due to central decisions. There are no unfunded mandates in the Danish system, although the municipalities sometimes complain of *under*funded mandates. But this system also means that the central government can use the municipal sector to realize savings on the central government budget. If the central government transfers functions out of the municipal sector or introduces regulation that makes the provision of municipal services less costly, the savings are not left in the municipal sector but transferred to the central government budget via downwards adjustments of the general block grant.

The third most important municipal revenue source is fees, cf. Figure 3.5. These are levied within the area of public utilities, where costs are fully financed by user charges, and social services, which can be partly financed by user charges. For example, 25 per cent of the costs of providing child care can be financed by user charges.

Finally, municipalities may to some extent finance expenditure by loans. Although borrowing is generally forbidden there are almost permanent exemptions, so-called automatic borrowing facilities (Juul 2006: 78–89). This means that investments within public utilities and a number of other areas can be financed by loans without formal permission from the central government. Municipalities may also seek formal permission from the interior minister to obtain loans to other types of expenditure. Finally, municipalities can also use overdraft facilities without special permission from the central government. However, these facilities must equal liquid facilities on average over any twelve months. If not, the municipality in question is put ‘under administration’ by the Interior Ministry. In practice, this means that the municipalities must seek an exemption from the rule on overdraft facilities from the Interior Ministry. By tradition, this requires an economic recovery plan to be presented to the Ministry. In sum, there is quite extensive regulation of municipal borrowing in Denmark.

At the regional level there are no taxes after the 2007 reform. Now grants from both the central government and the municipalities are the main regional income sources, cf. Figure 3.6. There are two types of central government grants. The first is a block grant that is distributed among the five regions according to expenditure needs. The second is an activity based grant that depends on performance in the health sector. There are also two types of municipal grants to the regions, although both are minor. The first is a block grant the size of which can be negotiated between the individual region and the municipalities within the region. The second is an activity based grant that depends on performance in the health sector. The purpose is to make the municipalities co-responsible for health expenditure in order to provide them with an incentive to establish effective prevention systems within the health care area and thus reduce demand for expensive hospital treatment.

As Figure 3.6 shows, fees are also important at the regional level. But they are only used in the social area where fees are levied on the municipalities for referring clients to the regions’ social institutions. This area must be fully financed by fees. No cross-subsidization from central government grants or municipal grants is allowed. Finally, borrowing is generally forbidden for the regions, but, again, some exemptions are allowed by the central government.

3.1.3 Effects of recent reforms

The local government reform in 2007

As noted above the 2007 local government reform amalgamated the previous 271 municipalities into 98 new large municipalities and the 14 counties into five new regions. In addition, it redistributed tasks across tiers and reformed the local government financial system, especially at the regional level. This may in the future lead to a higher quality of local service, but in the short term the major challenge was to prevent municipal expenditure from escalating. This is because amalgamations create common pool problems. Seen from the perspective of the old municipalities, the tax base of the new amalgamated municipality represents a common pool. There is an incentive to exploit it, since the benefits of doing so are private while the costs are collective. This is an example of the ”tragedy of the commons”.

The incentive to spend before closing time was recognized by the central government. To prevent overspending it introduced local spending restrictions that were gradually introduced and tightened over the reform years 2004–2006. In 2004, central regulation of local capital spending was introduced. Spending that exceeded the 2004 budget had to be submitted to the Ministry of Interior for approval. Since the 2004 budget was made in the autumn of 2003, this measure meant that all capital projects planned after the amalgamations were known had to be approved by the central authorities.

In 2005 restrictions were tightened. The approval system for capital spending was continued, but in addition a compulsory saving scheme was introduced. All local liquid assets above a certain amount (so-called 'surplus liquidity') had to be deposited at special bank accounts until 2007. This was the first restriction on local current expenditure.

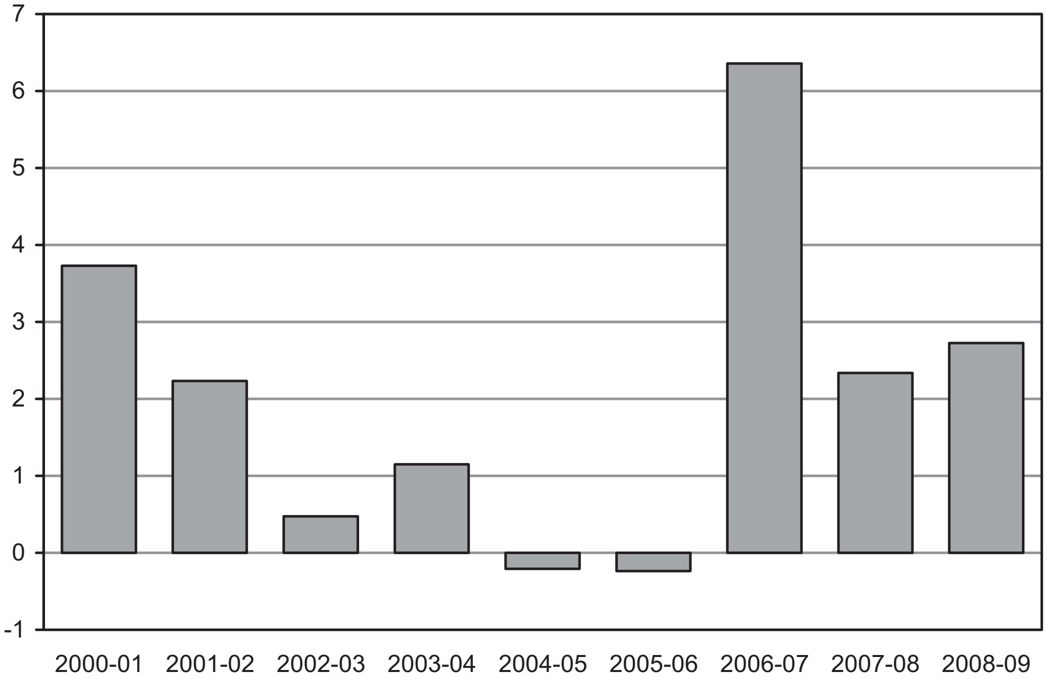
In 2006 restrictions were tightened again. This was a transitional year between the old and the new municipal structure. The new municipalities were established, but the old ones were not yet closed down. The recently elected new local councils in the amalgamated municipalities functioned as local amalgamation committees in charge of preparing the amalgamations. At the same time the old municipalities carried on for one final year as caretaker governments. Hoping that the amalgamation committees possessed more insight into local conditions, the central government trusted them with the approval system on capital spending. The amalgamation committees were also to approve all supplementary appropriations in the old municipalities, both current and capital ones. In addition to empowering the local amalgamation committees, the central government continued and strengthened its own regulation. Compulsory saving of local 'surplus liquidity' was continued in 2006. Furthermore, a tax freeze was introduced so local income and property taxes could not be raised above their 2005 levels. Finally, the central government introduced fees on all local supplementary appropriations in 2006.

At the same time, the ordinary 'budget cooperation' between the central government and the local government associations continued during these years. This is a system of annual negotiations in which the central government and the associations agree on spending and revenue levels in the local governments. Each year from 2004 until the amalgamations had been implemented in 2007, agreements were made on local government revenue and expenditure budgets. And each year the local government complied with the budget agreements – except from in 2006 when the budgeted expenditure level exceeded the agreed level. However, threatening to cut down on central government grants, the Minister of Finance persuaded the municipalities to adjust their budgets downwards. In every year before the amalgamations local government budgets have thus been in line with central government guide lines.

In total, an impressive array of central government precautions was put in place. But they were nonetheless only partially successful. The evidence suggests that the old municipalities engaged in overspending in the areas of capital expenditure, local roads, and schools just before the reform in 2007 (Blom-Hansen 2010).

This meant that the new municipalities were given a difficult start. The economic challenge was considerable also because a new amalgamated municipality must find a service level that is uniform throughout its territory. Unless this process is to lead to increasing expenditure, some citizens must accept a reduced service level. This is because the old municipalities differed in service levels, and averaging – by definition – also means reducing service. Since this process may be politically awkward, there is a pressure to harmonize service levels at the highest common denominator. This is probably one of the reasons why municipal expenditure increased immediately after the 2007 reform. The increase is shown in Figure 3.8. As can be seen, municipal expenditure was kept constant during the reform years 2004–2006. But in 2007 local expenditure began to grow again, although most of the increase in this year is due to the functions which the municipalities took over from the old counties. This accounts for about two thirds of the increase in this year (Ministry of the Interior 2007; 2009a). So there has been an annual real growth of about 2–3 per cent in the years following the reform. This development has again led to a new round of central government restrictions (which are discussed in more detail in section 3.1.4 below on the effects of the local fiscal system).

Figure 3.8. Annual real growth in municipal expenditure in 2000–2009 (per cent)



Note: The figure shows annual percentage change in municipal expenditure in 2009 prices (inflator: municipal price and wage index).

Source: Statistics Denmark.

The employment reform in 2009

Employment policy has traditionally been a divided area in Denmark. The central government has been responsible for persons who carry insurance with an unemployment fund, while municipalities have been responsible for persons without insurance who therefore have to rely on social security in case of unemployment. In 2009 the system was unified and placed with the municipalities. This was widely hailed as a victory for the municipalities whose position in the public sector appeared stronger than ever. However, this new function did not come without conditions. The new regime is not only heavily regulated by laws and administrative decrees, but also by requirements to systemically consult the organisations of employers and employees who have traditionally had privileged access to central decision-makers (Christiansen & Klitgaard 2009).

This set-up follows a path that was begun with the local government reform in 2007 which transferred a number of functions from the old counties to the municipalities, most importantly specialized social services and selected health care tasks. But although the new municipalities were larger than the old ones, they are still too small to solve these tasks on their own. So a new system of municipal joint ventures, cooperative arrangements with the region and central government supervision had to be installed. In short the employment reform in 2009 continued a trend towards more local functions, but less local autonomy.

3.1.4 Evaluation of the present system

The 2007 local government reform and the 2009 employment reform have given rise to three challenges. First, the reforms have strengthened the municipalities as implementers of national policies and left more functions at the local level. This leads to a challenge of coordinating policies across both tiers and neighbouring municipalities. Second, the 2007 reform fundamentally reformed the regional level. The central government did not want a strong regional level and deliberately created weak regions. For the regions the challenge is demonstrate that they are not too weak to survive. Third, keeping municipal and regional expenditure within limits set by the central government has proven difficult, and the central government has found it necessary to install systems of tight control and thus reducing local autonomy. This is supposed to be a temporary arrangement, but relaxing control without causing an explosion in local expenditure and taxation is a challenge. In the following these three challenges are discussed in more detail.

Vertical and horizontal coordination. In the new system municipalities and regions have to coordinate their actions. This is especially the case in three areas. In the health care area, the regions are responsible for most of both primary and secondary care, but the municipalities have taken over health care prevention and rehabilitation. In the area of specialized social services the municipalities have taken over all formal responsibility, but a number of institutions are run by the regions. Finally, in the area of regional planning and growth municipalities and regions are required to formulate policies together.

To promote coordination the central government requires that each region and the municipalities within the region must negotiate and adopt relatively detailed agreements. These agreements are political, not legal; strictly speaking they are declarations of intent. However, the central government has carefully defined how they are to be made, for example by specifying participating actors and negotiation procedures, it has introduced special coordinating bodies where negations are to take place, for instance the new municipal-regional contact commission, and in some areas the central government has to formally endorse the agreements.

This system of semi-voluntary vertical coordination is demanding for the municipalities. Each region contains 11–29 municipalities whose interests are not necessarily identical since they differ in terms of size, demography, business conditions, and political ideology. They are vulnerable to a divide-and-rule strategy from the region's side. To avoid this scenario the municipalities' national association, *Local Government Denmark*, has created regional branches, *Municipal Contact Councils*. In effects, these councils are the municipalities' regional interest organisation. Their purpose is to enable the municipalities to match the region in negotiations. They have no formal decision-making power, but can act as mediators and providers of information (Heeager 2009).

It still remains to be seen whether vertical and horizontal coordination functions in practice in the new system. One cause for concern is the fact that central, regional and municipal interests are seldom identical. So can a system of semi-voluntary negotiations achieve sufficient coordination?

Can the regions survive? The old counties and their national association, the *Association of County Councils (Amtsrådsforeningen)*, lost the battle about the 2007 reform. The five regions that were built on the ruins of the 14 old counties were crippled institutions. First, compared to the old counties, the functional competence of the new regions is circumscribed. The old counties had a general competence, that is, they could take regional initiatives in all areas that were not strictly forbidden by law. The new regions have no general competence. They can only deal with tasks that are explicitly allowed by law. These tasks are basically limited to primary and secondary health care, although the regions are also responsible for running a number of social institutions and for coordinating regional development activities. But for all practical purposes, the new regions are single-purpose entities.

Second, the new regions have a reduced political capacity. The old counties had a committee system in which the politicians specialized in the functions for which their committee was responsible. The regions only have a council and an executive committee. The central government's rationale is that since the regions are practically single-purpose entities, a committee system does not make sense (Krogh 2008). However, seen from the regions' perspective, this political system makes for less specialization and professionalization among politicians, reduced distribution of power, and more concentration of influence with the regional chairman, the only full-time regional politician in the new system. Speculations about both 'presidentialization' of the regional chairman and recruitment problems for the regional council are already raised (Christoffersen and Klausen 2009: 157–167; Krogh and Skött 2008: 44–6).

Third, the regions' economic autonomy is reduced. The counties had independent taxation rights, but the regions cannot raise taxes. They are dependent on grants, primarily from the central government, but also from the municipalities within the region. On the one hand, this means that the regions are at the mercy of the central government and the municipalities. On the other hand, it also means that decision-making competence and economic responsibility are no longer connected at the regional level. The regions decide the expenditure side of the budget – that is, activity and service levels within the health area – but the central government pays the bill. The regions thus have an incentive to join forces with the interest organizations in the health care area and press the central government for increased funding. A new expenditure pressure is thus built into the system (Blom-Hansen et al. 2006).

Fourth, the new regions have less control over their labour force. The personnel at the regional institutions and the regional administrative offices are employed by the region. Their wages and terms of employment are decided in collective agreements made by the regions' national association, *Danish Regions*, and the trade unions of the personnel. But compared to the old counties' national association, the new association has less autonomy to negotiate these agreements. The regions' position is now decided by a board composed of representatives from the regions, the municipalities, and the central government. The latter can veto agreements that do not respect the central government's expenditure policies, which turns wage negotiations into a complicated game of alliance building on the employers' side of the negotiation table.

In sum, the new regions are given a difficult start. Compared to the old counties they are vulnerable organizations. Not only do they have to build up a new political-administrative system on the ruins of the old counties, they also have to constantly defend their position in the public sector. The debate about the proper organisation of the regional level is not over, and speculations abound about abolishing the regions and establishing hospitals as independent organisations controlled by user boards. For example, when it became clear in the spring of 2010 that the counties' 2009 accounts ended in deficit, the Danish People's Party, the government's permanent support party, declared that it was time to plan the abolishment of the regions. The Interior Minister followed up by stating that the regions are "up for examination" (*Politiken*, 27 March 2010). In June 2010 the Conservative Party, one of the two government parties, suggested that the five regions be replaced with three hospital districts run by indirectly elected boards (*Berlingske Tidende*, 21 June 2010). Although this proposal was quickly rejected by the other government party, the Liberal party, it shows that the existence of the regions cannot be taken for granted. The 2007 government reform introduced a regional tier whose sustainability is far from self-evident. Their existence is probably only guaranteed as long as an effective alternative institutional set-up for the hospital sector is not available.

Controlling municipal and regional expenditure. In the new system after the reforms in 2007 and 2009 more Danish public expenditure than ever is decided by municipalities and regions. This means that macroeconomic control of the local and regional government sector is more relevant than ever. But keeping local and regional expenditure within central government guidelines has proven difficult.

At the municipal level, the central government tightly controlled expenditure and taxation in the reform years 2004–2007. This was widely accepted, but on the implicit condition that control should be eased once the reform was in place. In 2007 the government lived up to this expectation and abolished the control instruments and negotiated a traditional economic agreement with the municipal national association, *Local Government Denmark*, for the coming year 2008. Macroeconomic control was to be conducted just as before the reform – that is, by negotiations and agreements. However, the municipalities broke the agreement. The agreement was made in the summer of 2007, but when the individual municipalities enacted their budgets three months later in October, both expenditure and taxation exceeded the agreed guidelines dramatically.

The government's immediate reaction was to accept the municipal budgets. This was probably because national elections were held at the same time, and intervening in local budgets meant taking the responsibility for unpopular cuts in local welfare. But after the elections the government introduced two novel control instruments. First, if the municipalities raise taxes above the agreed guidelines, the general block grant is reduced by the same amount. Second, part of the general block is made conditional on the agreement being kept when local budgets are made.

These new rules of the game have completely changed the annual negotiations between the central government and *Local Government Denmark*. The incentive to keep the agreement is now so strong that there is hardly any doubt that the agreement will be kept. And both the 2009 and 2010 agreement bore witness to this fact.

In sum, macroeconomic control seems to have been reinstated. But the price is high. No municipality dares lower its taxes anymore, so the system has become inflexible and local autonomy is severely reduced. This may be bad or good depending on political taste. But the new rules of the game introduce some perverse incentives in the system that should be cause for worry irrespective of political taste. They are discussed in more detail in the next section.

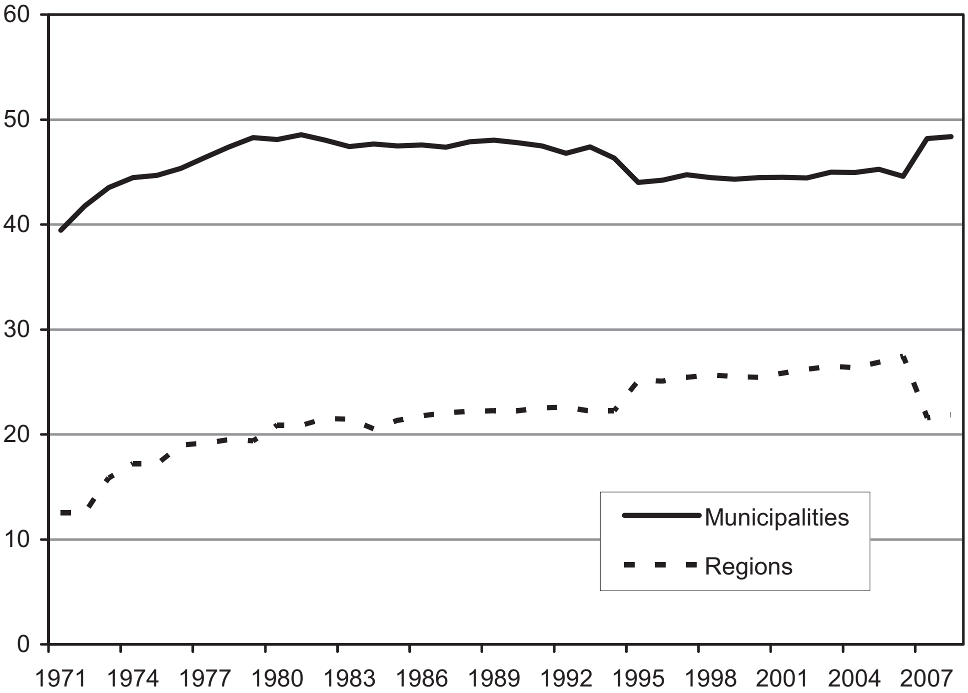
First we need to take a look at economic control at the regional level. Since the regions do not possess any taxation rights but are financed by grants, the government is in principle in firm control of the level of regional expenditure.

The years after the 2007 reform have also shown that the regions' budgets follow the central government's guidelines. However, it has proven difficult to keep the budgets. Especially in 2009 a considerable deficit arose. There are multiple reasons for this development, but one reason is the budget system which the central government has imposed on the regions. It is a combination of traditional spending caps and activity based financing. The major part of the regions' expenditure is financed by a block grant from the central government. This grant is fixed so it represents a traditional spending cap approach. However, there is also a special health grant from the central government that depends on activity levels – but up to a limit. Once the limit is reached, activity must stop. Otherwise the regions are heading towards a deficit. However, fine-tuning when to stop activity under this new regime has proven difficult in practice for both technical and political reasons.

3.1.5 Effects of the local fiscal system on macroeconomic performance

Danish municipalities and regions are heavy weights in the Danish public sector. As Figure 3.9 shows they have been responsible for about two thirds of public consumption since the local government reform in 1970. The 2007 reform increased the municipalities' share because they took over tasks from old counties; and the reform reduced the regional share because many of the old counties' functions were not transferred to the new regions, but taken over by either the central government or the municipalities.

Figure 3.9. Municipalities' and regions' share of public consumption in 1971–2008



Source: Statistics Denmark

Since the municipalities have both taxation rights and autonomy to decide service levels in many of their expenditure areas and since the same was true for the old counties (but not the new regions), coordinating the economic dispositions of the local and regional government sector with the central government's macroeconomic policies has been a challenge throughout the past 30–40 years.

The Danish solution to this challenge has been a system of annual negotiations and agreements between the central government and the associations of local governments (*Local Government Denmark*) and regional governments (*Amtsrådsforeningen* before 2007; *Danske Regioner* after 2007), the socalled budgetary cooperation between central, local and regional government.

When evaluating this system the first yardstick is to examine the extent to which the agreements are kept. The record for the municipalities for the period 1980–2010 is shown in Table 3.3. It shows, first, that this system has been in operation almost without interruptions for the whole period. It is an institution in Danish intergovernmental relations. Second, it shows that it has varied over time whether the object of control has been the expenditure or revenue side of local budgets. But since local budgets must balance, this is mostly a technical question. Third, the table shows that the annual agreements are far from kept every year. The system is obviously not perfect. But it should be kept in mind that although broken, the agreed guidelines are often only broken slightly. This is actually no small achievement since keeping the agreement requires a coordinated effort from 98 municipalities (273 before 2007). Furthermore, a comparative analysis of Denmark, Norway and Sweden for the period 1980-1997 shows that Norway and Sweden have not been more successful in controlling local expenditure (Blom-Hansen 1998). In other words, there are no obvious alternative systems of control.

Table 3.3. Annual economic agreements between the Danish central government and Local Government Denmark in 1980–2010

Budget year	Core element of agreement	Agreement kept?
1980	Max. 3 per cent growth in expenditure	Almost
1981	Max. 2 per cent growth in expenditure	Yes
1982	Max. 1 per cent growth in expenditure	Yes
1983	Max. 1 per cent growth in expenditure	No
1984	Reduction of expenditure by 2 per cent. Unchanged tax level.	Yes
1985	Unchanged expenditure and tax level	No
1986	(no agreement)	-
1987	Unchanged expenditure	No
1988	Unchanged expenditure	No
1989	Unchanged expenditure and tax level	Yes
1990	Reduction of tax level by 0.2 percentage points	Almost
1991	Reduction of tax level by 0.2 percentage points	No
1992	Unchanged tax level	No
1993	Unchanged tax level	No
1994	Unchanged tax level	Yes
1995	Unchanged tax level	No
1996	Tax level to be kept almost unchanged	Almost
1997	Unchanged tax level	No
1998	Unchanged tax level	Yes
1999	Unchanged tax level. Max 1 per cent growth in expenditure on services	No
2000	Unchanged tax level. Max 1 per cent growth in expenditure on services	Almost
2001	Unchanged tax level. Max 1 per cent growth in expenditure on services	Almost
2002	Unchanged tax level. Max 1 per cent growth in expenditure on services	No
2003	Unchanged tax level. Max 0.7 per cent growth in expenditure on services	Yes
2004	Unchanged tax level. Max 0.7 per cent growth in expenditure on services	Yes
2005	Unchanged tax level. Max 0.3 per cent growth in expenditure on services	No
2006	Expenditure on services equals 146 bill. DKK	No
2007	Expenditure on services equals 194 bill. DKK	Yes
2008	Expenditure on services equals 205 bill. DKK; taxes to be raised by 750 mill. DKK	No
2009	Expenditure on services equals 219 bill. DKK	Yes
2010	Expenditure on services equals 228 bill. DKK	Yes

Note: In some years there may be different interpretations of the extent to which the agreement is kept. The table shows the central government's interpretation.
Source: Updated version based on Serritzlew and Blom-Hansen (2008)

In sum, the Danish system appears relatively efficient. It enables the central government to effectively use the local and regional government sector for macroeconomic control purposes. One recent striking example of this fact is the convergence program that the Danish government introduced in February 2010 as part of its obligation under the EU rules (Finance Ministry 2010b). According to this program Denmark needs to cut public expenditure by 31 billion DKK, which is equivalent to approximately five per cent of the central government's budget. But thanks to the annual negotiation system with the municipalities, the central government can incorporate local government budgets in its thoughts on how to deal with this problem. As the central government states in the convergence program, "the concrete adjustment of the finance policy in 2011 will be decided in the negotiations with the municipalities in May and the process around the annual finance bill in the autumn" (Finance Ministry 2010b: 14; my translation).

At the same time, however, the Danish macroeconomic control system is plagued by a number of perverse incentives that have grown in importance over the years. They are all due to the fact that the agreement is an informal, negotiated outcome made by the municipalities' association, *Local Government Denmark*. The association cannot make a legally binding agreement on behalf of its members. So in reality the annual agreement is a declaration of intent.

The first incentive problem is a collective action problem. The annual agreement is general and covers all municipalities. If an individual municipality does not want to follow the guidelines it can ignore them and refer to the collective character of the agreement. In other words, the collective and private interests of the municipalities may not coincide.

Second, it is difficult to identify who exactly breaks the agreement when it is not kept. Since it is collective, the agreement is not necessarily broken by the municipality that raises taxes and expenditure. The culprit may be the municipality that despite a positive economic situation does not reduce taxes and expenditure so that other municipalities can adjust upwards. This problem makes it difficult to implement effective sanctions when the agreement is broken.

Third, the system may lead to perverse incentives in a temporal perspective. If the municipalities fear sanctions at some future point, they may be reluctant to lower taxes and expenditure because this would put them in a vulnerable situation and make the handling of potential future sanctions more difficult. This problem is probably the main reason why fewer and fewer municipalities adjust their taxes downwards.

Finally, the annual agreements may lead to less local variation. They contain clear signals about what the central government considers proper behaviour in terms of both tax and expenditure policy. Although these signals are negotiated, the negotiating partners are not equal. There is always a risk of central intervention which over time may function as a pressure to live up to these guidelines. Figure 3.7 above showed that municipal tax rate become more and more alike over time. The same pattern has been identified on the expenditure side of the budget (Houlberg 2000).

In total, the Danish system of annual negotiations and agreements is handicapped by severe incentive problems. When the agreement for 2008, the first agreement after the 2007 reform, was dramatically broken, the government chose to short-circuit the system by introducing the harsh control instruments described above. This has made the annual agreement much more credible but also introduced new incentive problems. In effect, the new system locks the tax rate of the individual municipalities because no one dares lower taxation. Taxation, however, is locked at an historically arbitrary level. This again means that tensions are built into the system because some municipalities face rising costs, for instance due to the local demographic development. They can react by either pressurising the central government for help or by cutting down local welfare. It is doubtful whether this state of affairs is sustainable in the longer run.

Before a final verdict on the Danish negotiation system is made, it should also be mentioned that the annual negotiations function as an arena where all types of issues and problems in intergovernmental relations may be brought up. The agreements normally cover 15–20 pages. But only 3–4 pages deal with tax and expenditure policy. The rest deals with problems in the various areas under municipal control. The agreements normally include a series of new initiatives on the provision of local service, cutting down red tape, introducing new municipal control instruments, and so on. Since all this is done in collaboration between the central government and Local Government Denmark, and since initiatives are often based on reports from joint working groups or commissions, they are made in a relatively information-rich environment. In this way the system of annual agreements may lead to more informed policies and thus maybe also to a more efficient local government sector than would otherwise be the case.

At the regional level a similar negotiation system has been in place since around 1980. However, after the 2007 reform and the abolishment of the regional taxation right, negotiations have changed. They now concern the annual block grant to the regions and activity levels in the health care area. Since the central government directly controls the size of the block grants, the regions do not have much to offer in return for influence on central policies. Consequently, the negotiations have taken on a more hierarchical nature after 2007.

In conclusion, macroeconomic control of local and regional governments in Denmark has traditionally been done by annual negotiations. After the 2007 local government reform these negotiations have increasingly been supplemented by more hierarchical control instruments. This had led to tensions which will become more and more serious over time. But so far no solutions to this problem have been devised.

3.2 Local government in Norway

Lars-Erik Borge

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.

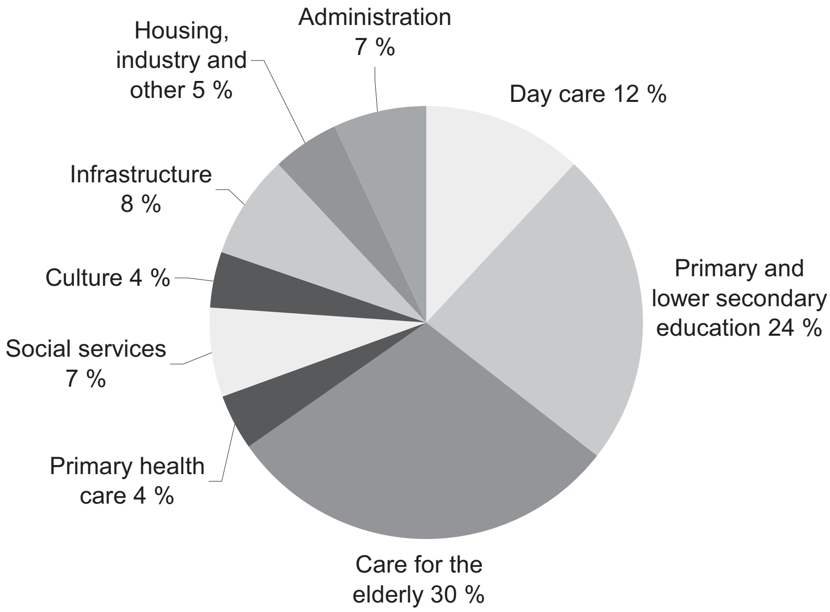
There is considerable variation in population size across the municipalities, from a few hundred in the smallest rural communities to nearly 600,000 in the capital Oslo. More than 50% of the municipalities have less than 5,000 inhabitants. Despite the huge variation in population size, all municipalities 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.

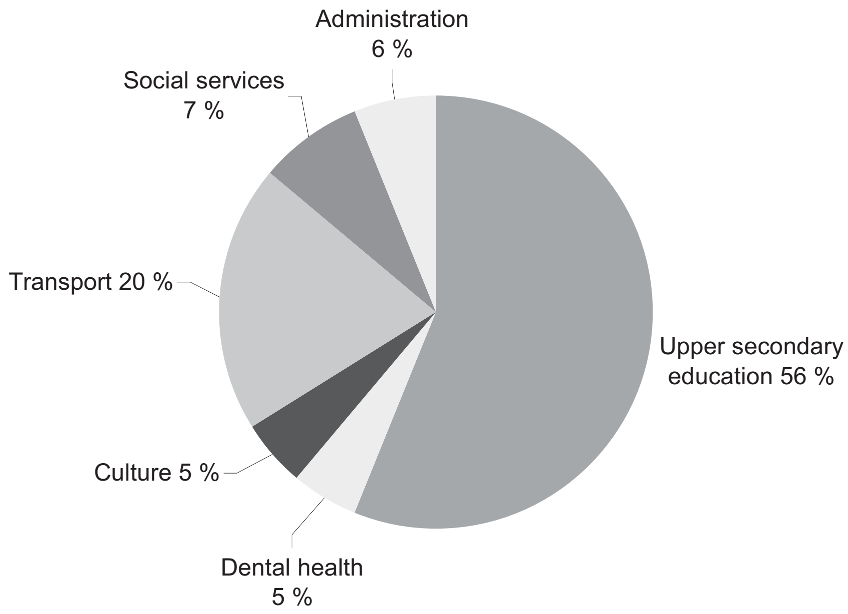
Figure 3.10. Municipal service sectors, percent of current expenditures in 2008



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 wealth[4] 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.

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[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

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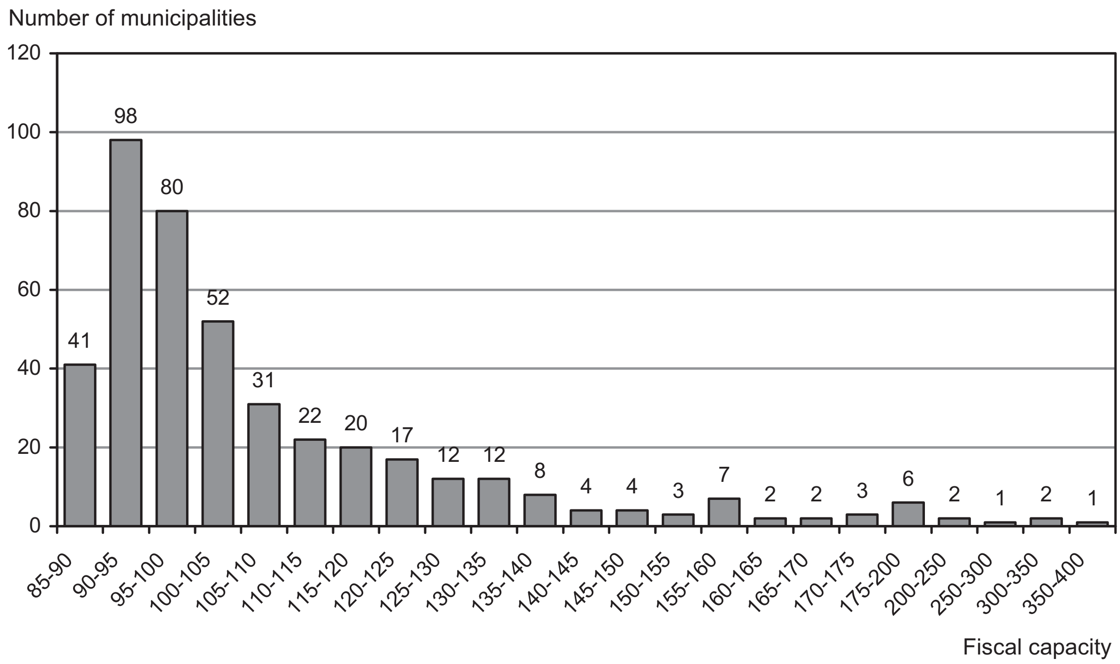
[12] In 2005 a government commission (headed by the author of this chapter) proposed a major simplification of the regional policy grants. The political outcome (as described in the main text) was to make the system even more complicated.

[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.

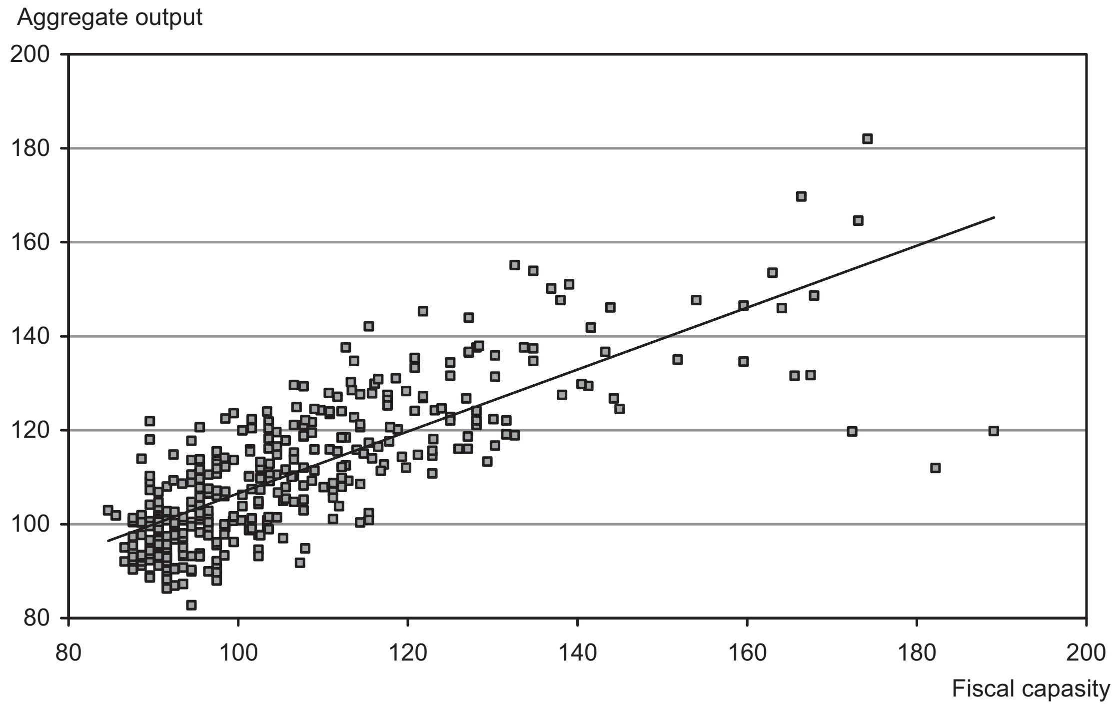
The main economic argument in favor of local tax discretion is related to the decentralization theorem of Oates (1972): When the local tax rate can adjust to varying spending preferences and cost conditions, a decentralization gain can be achieved compared to a situation with a uniform tax rate decided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

3.3 Local government in Sweden

Matz Dahlberg

3.3.1 Introduction

In this chapter the Swedish case will be presented. After a description of the organization and tasks for the local governments in section 3.3.2, section 3.3.3 will discuss which effects different reforms affecting the municipalities have had. Section 3.3.4 will discuss the effects of decentralization per se, section 3.3.5 will discuss reforms that might be considered for Sweden, and section 3.3.6 will conclude with some comments on the Finnish system.

3.3.2 Swedish local government: A short description

Organization

There are two types of local decision-making bodies in Sweden, the municipalities and the counties. In the year 2010, there are 21 counties and 290 municipalities. The two types of local governments are not hierarchically dependent on each other, but are rather horizontally lined under the central government.

Elections to the central government and to the county and municipal councils are held on the same day (third Sunday in September) every fourth year. Sweden has a proportional election system, and the next elections will be held on September 19, 2010.

Sweden has a long tradition of strong local self-government. Since 1974 the right to local self-government is given in the constitution and both the municipalities and the counties can set their own local income tax rates (the income tax is the only local tax), they can decide on spending levels (above certain required minimum levels) and they are allowed to borrow freely on both domestic and international credit markets. The Local Government Act contains provisions on the powers of the local councils, on the elected representatives and on the decision-making procedures. When the municipalities or the counties are provided with new tasks, their right to self-government must be taken into account.

The local governments constitute an important part of the Swedish economy. Their expenditures amount to approximately 24 percent of GDP and they employ 25 percent of all employed people in Sweden (Regeringens skrivelse, 2010). Of the two local governments, the municipalities are responsible for more tasks than the counties and handle a much larger budget. The counties are mainly responsible for health and medical care, while the municipalities are responsible for several services related to social welfare, daycare, schooling, elderly care and local infrastructure. The municipalities' total expenditures amount to a little less than 20 percent of GDP, and they solely employ approximately 20 percent of all employed individuals in Sweden. Given their size and the importance of their services, it is no surprise that a clear majority of all local government reforms have been related to the municipalities. It is also the case that it is almost exclusively the reforms related to the municipalities that has been evaluated, probably due to the fact that the number of municipalities provide a larger variation in the data than the number of counties do, a variation that eases the identification of the sought after effects. For these reasons, this chapter will concentrate on the municipalities and the reforms related to them.

Tasks for the municipalities

The municipalities have a broad range of areas for which they are responsible. According to the law, some areas are compulsory for the municipalities, such as education, child care, social care (including care for the elderly and welfare assistance), local planning, waste management, water and sewage. Examples of areas that are not compulsory are culture, recreational activities, housing and energy.[20]

The areas, and the spending within each of these areas, are given in Table 3.7. As is clear from the table, the most important areas, at least in an economic sense, are schooling, elderly care, child care and social care.

A majority of the services that the municipalities provide are labor intensive, implying that many individuals have the municipalities as their employer. As mentioned earlier, the municipalities employ approximately 20 percent of all people in Sweden. An implication is then also that wage costs constitute an important part of the municipalities' total expenditures; in the year 2008, their share was approximately 50 percent (including payroll taxes).

[20] For a more detailed discussion on these issues, see Boadway and Mörk (2003).

Revenues for the municipalities

The three main revenue sources for the municipalities are local tax revenues, generated entirely from the local income tax and the local income tax base, intergovernmental grants, and fees. In the year 2008, each of these sources amounted to 63 (tax revenues), 15 (grants) and 6 (fees) percent of total revenues (c.f. Table 3.8).

Table 3.7. Municipal spending by area (for the year 2008).

Area	Costs (million SEK)	Costs (% of total)
Education	133,940	30
Assistance for the elderly	91,733	21
Child care	62,472	14
Assistance for the disabled	51,682	12
Individual and family assistance	30,815	7
Infrastructure, shelter, etc	33,058	7
Recreation	12,141	3
Culture	10,730	2
Specially targeted activities	10,850	2
Political activity	5,305	1
Other activities	4,389	1
Total	**447,115**	**100**

Source: Statistics Sweden, Statistiska meddelanden, serie OE 25; Statistikdatabasen: Offentlig ekonomi. Also published in Statistical Yearbook for 2010, Public Finances.

Table 3.8. Revenues for the municipalities (in the year 2008).

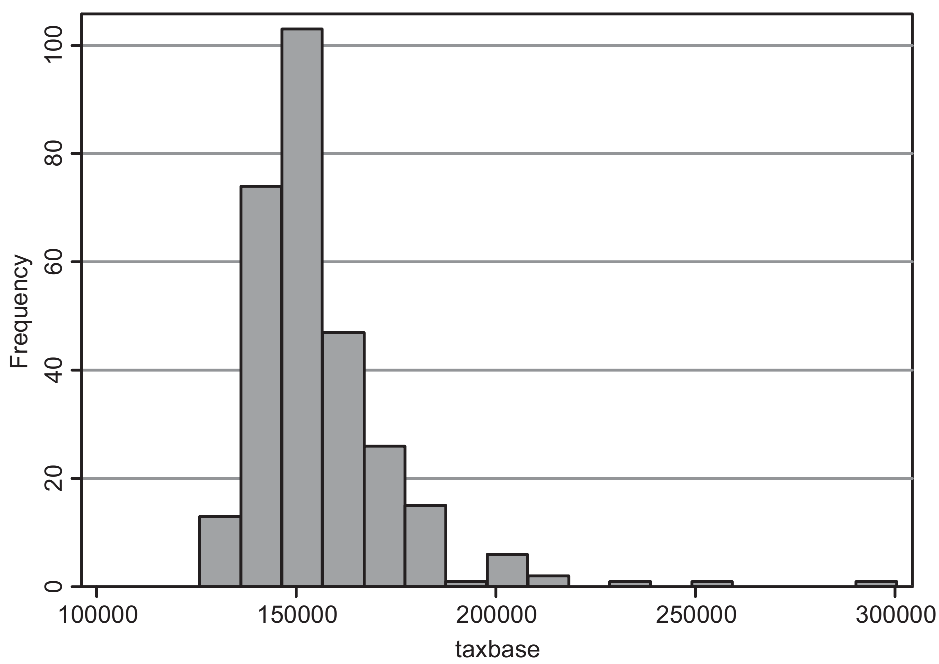
Revenue source	Revenues (million SEK)	Revenues (% of total)
Tax revenues	330,645	63
Grants	77,061	15
Fees	29,963	6
Other revenues	84,047	16
Total	**521,716**	**100**

Source: Statistics Sweden, Statistiska meddelanden, serie OE 25; Statistikdatabasen: Offentlig ekonomi. Also published in Statistical Yearbook for 2010, Public Finances.

In such a decentralized system as the Swedish, where Sweden must be considered as one of the most decentralized countries in the world, intergovernmental grants naturally play an important role. The intergovernmental grant system in Sweden contains three main parts: tax equalizing grants, cost equalizing grants, and structural grants. In the year 2008, the total amount of grants was, on net, estimated to be around 50 billion SEK (Sveriges Kommuner och Landsting och Finansdepartementet, 2008). The tax equalizing grants constitute the absolute largest part (approximately 52 billion SEK in 2008), followed by the cost equalizing grants (approximately 5 billion SEK in 2008) and structural grants (approximately 1.5 billion SEK in 2008).

The main purpose of the tax equalizing grants is to equalize differences in the local tax base. As is clear from the frequency distribution of the local tax base in the year 2009, presented in Figure 3.14, there exist large differences in the municipal tax bases; from a minimum of 125,829 SEK per capita to a maximum of 300,491 SEK per capita. It is, however, also clear that the majority of the municipalities are relatively centered on the mean tax base (which is 155,642 SEK per capita).

Figure 3.14. Frequency distribution of local tax bases in the year 2009



Source: Statistic Sweden’s statistical database (statistikdatabas), available at www.scb.se.

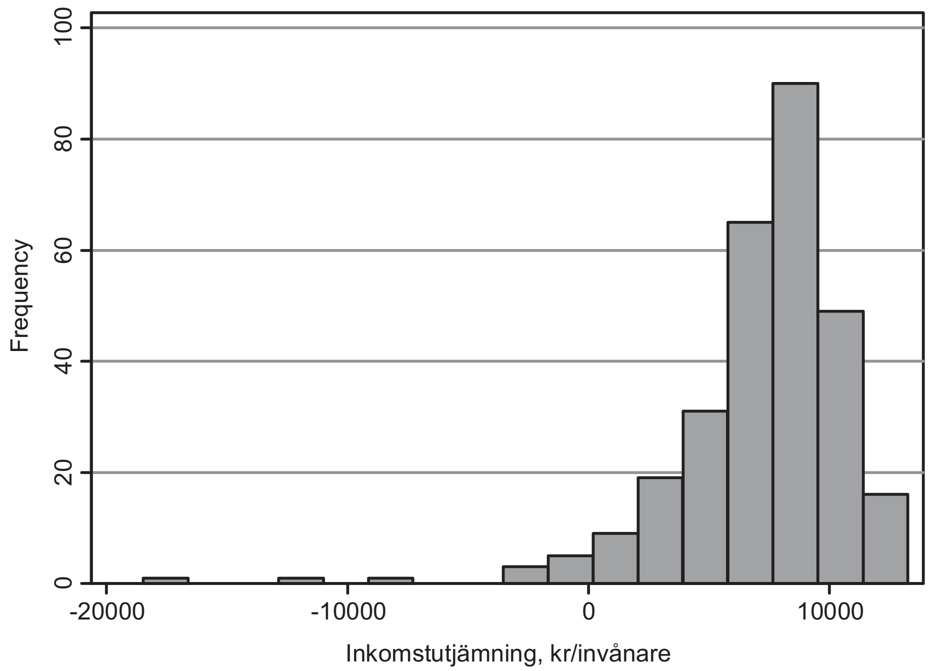
The tax equalizing grants are based on the difference between the own taxable income and a tax base that corresponds to 115 percent of the average tax base in the country. For receiving municipalities, i.e. municipalities with a tax base lower than 115 percent of the average tax base in the country, the grants are calculated from 95 percent of the average tax rate in the country in the year 2003 (corrected for county-wise tax exchanges between the counties and the municipalities that followed from switching of responsibilities from the counties to the municipalities in the 1990s). For municipalities that have to pay to the system, i.e. municipalities with a tax base higher than 115 percent of the average tax base in the country, the fee is calculated from 85 percent of the same average tax base. The tax equalizing grant for a receiving municipality is then calculated as follows:

(1) $$Grant_j = 0,95t_{2003}(1,15\overline{SB} - SB_j)$$

where the grant per capita in municipality j is given by $Grant_j$, t_{2003} is the average tax rate in the country in the year 2003, $\overline{SB}$ is the average tax base (per capita) and SB_j is the municipality's own tax base. A municipality with a tax base below 115 percent of the average tax base in the country thus gets 95 percent of the deviation to the average tax base covered. In an international comparison, this is a high degree of equalization. In the year 2008, eleven of the 290 municipalities had a tax base that was higher than 115 percent of the average tax base in the country, and that hence had to pay a fee to the system. Nine of these eleven municipalities are located in the Stockholm area, two in the Malmö area.

The tax equalizing grants were estimated to be around 52 billion SEK in 2008 and the tax equalizing fee to be around 3,7 billion SEK (Sveriges Kommuner och Landsting och Finansdepartementet, 2008). The tax equalizing grant system is hence mainly state financed, a consequence of the fact that general grants from the year 2005 is part of the tax equalizing grants. Figure 3.15 shows the frequency distribution of the tax equalizing grants over the municipalities in 2008. As is clear from the figure, there is a large variation in these grants, from the municipality that pays a fee of 18,461 SEK per capita to the municipality that receives 13,257 SEK per capita.

Figure 3.15. Frequency distribution of tax equalizing grants over municipalities for year 2008.



Source: Statistic Sweden's statistical database (statistikdatabas), available at www.scb.se.

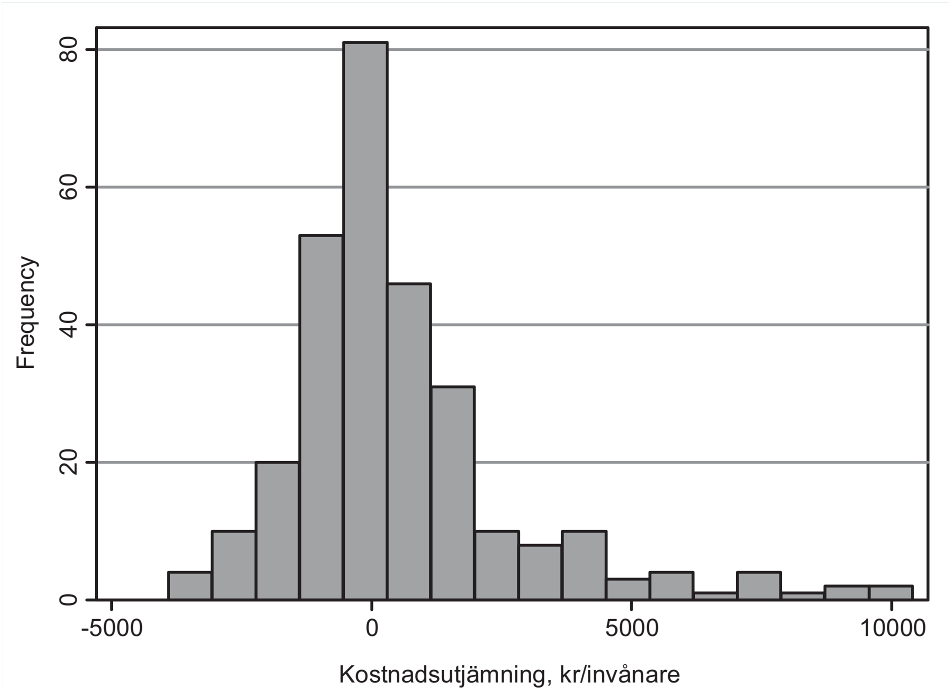
The purpose with the cost equalizing grants is to equalize for costs that the municipalities themselves cannot affect (structural cost differences), and where the principle is to only equalize for structural cost differences within areas that are compulsory fo the municipalities.

The calculations of the cost equalizing grants are based on the ”standard costs method”, which consists of nine different models: one for child care, one for compulsory school, one for high school, one for elderly care, one for individual- and family care, one for children with a foreign background, one for population changes, one for housing structure, one for wage structure, and one for public transportation (joint between the municipalities and the counties). In sum, the standard costs method equalizes for a large amount of variables (dealing with different aspects of the municipalities' demographic structure, ethnicity, socio-economic situation, and geography).

The municipalities can affect how much cost equalizing grants to receive by trying to affect de variables that determine the distribution of these grants. While some factors are hard to affect (like, for example, geographic location), others can be affected. The municipalities can, for example, through their policies affect individuals' migration decision (and thereby the demographic and socio-economic structure in the municipality) and the share of foreigners in the municipality. Hence, the variables cannot be considered to be completely exogenous, something that must be hard to fulfill in reality.

The cost equalizing grants to the municipalities were estimated to be 5,2 billion SEK in 2008 (Sveriges Kommuner och Landsting och Finansdepartementet, 2008). The cost equalizing grants constitute a financially neutral system (from the State's point of view). From Figure 3.16 it is clear that the variation in the cost equalizing grants is lower than the variation in the tax equalizing grants (c.f. Figure 3.15), but it still varies from a municipality that contributes with 3,905 SEK per capita to a municipality that receives a grant of 10,409 SEK per capita.

Figure 3.16. Distribution of cost equalizing grants over the municipalities, for the year 2008.

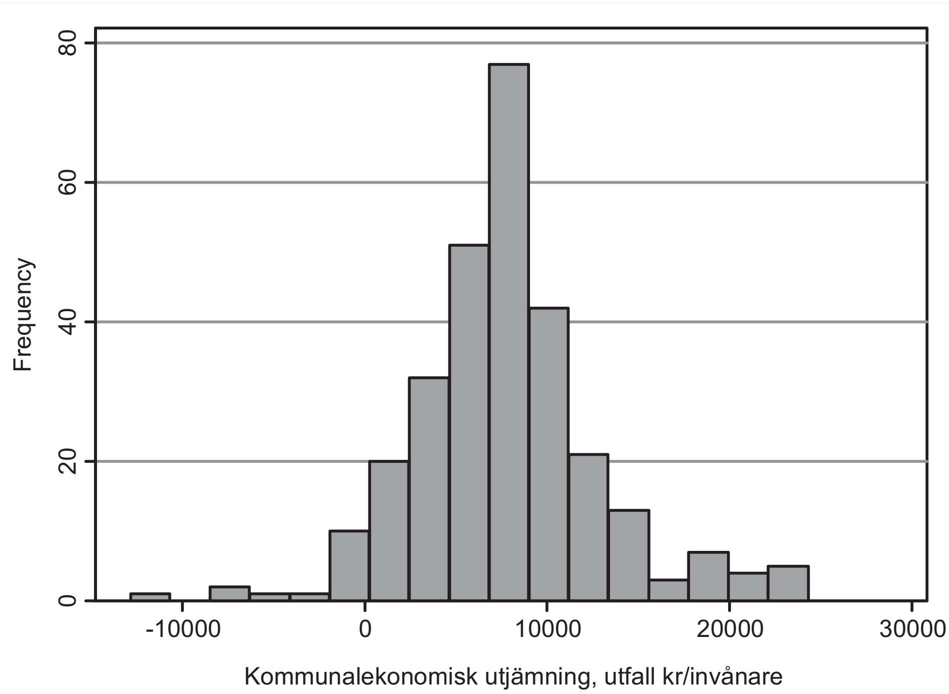


Source: Statistic Sweden's statistical database (statistikdatabas), available at www.scb.se.

The structural grants are related to regional politics and their aim is to strengthen municipalities with a small population and/or municipalities with a problematic labor market. In the year 2008, the structural grants are estimated to be 1.5 billion SEK and 94 out of the 290 municipalities will receive these grants. Of the 94 municipalities that will receive structural grants, the amounts varies from 4 SEK per capita to 5,438 SEK per capita.

What does the picture look like when taking all grants together? The frequency distribution over municipalities of the sum of all grants is given in Figure 3.17. As is clear from the Figure, the municipal equalization system in Sweden plays an important role in equalizing incomes over the municipalities, with a variation from the municipality that pays 12,860 SEK per capita to the system to the municipality that receives 24,313 SEK per capita from the system.

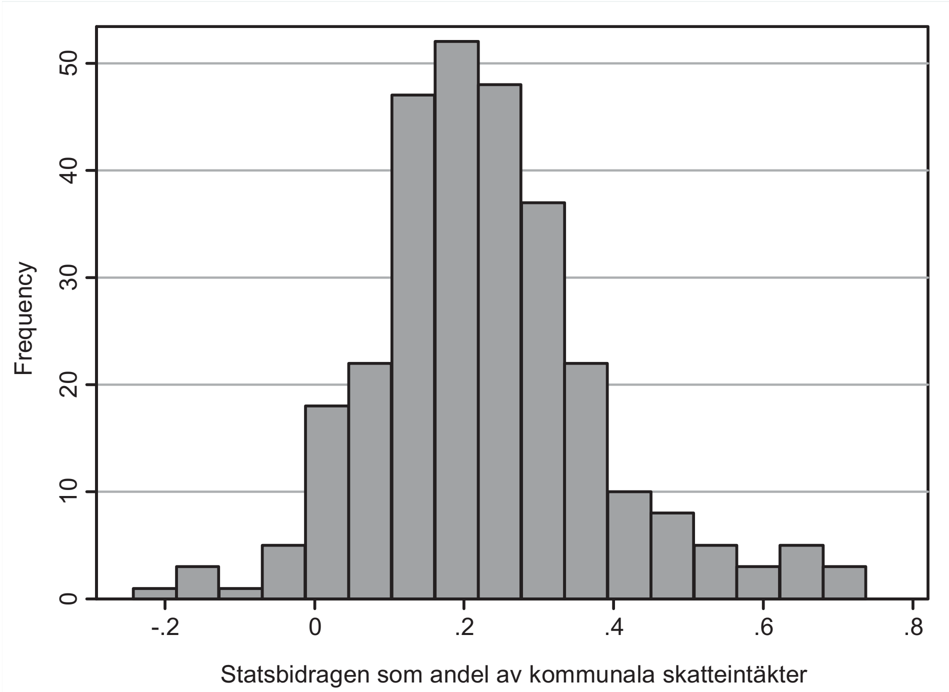
Figure 3.17. Frequency distribution of the sum of all grants



Source: Statistic Sweden's statistical database (statistikdatabas), available at www.scb.se.

A related, and perhaps even more important, question is how important the intergovernmental grants are for the municipalities relative to their own-generated incomes. From Table 3.8 we note that the grants constitute 15 percent of the municipalities' total revenues on average. Compared to many other countries this is a fairly low share, implying that there is a low degree of vertical fiscal imbalance in Sweden on average. The variation over municipalities on how dependent they are on intergovernmental grants is however quite large. To illustrate this I have calculated the ratio between the total amount of grants that each municipality receives per capita from the grant system (i.e., the data presented in Figure 3.17) and each municipality's own-generated tax revenues. The distribution of this ratio is given in Figure 3.18. It is clear that the grants constitute a relatively large share of the own-generated tax revenues for some of the municipalities; 17 municipalities have a grant share that is larger than 50 percent, and 7 municipalities have a grant share larger than 65 percent.

Figure 3.18. The degree to which the municipalities depend on intergovernmental grants in the year 2008. Frequency distribution over the municipalities of the grants' share of the municipal tax revenues (a measure of vertical fiscal imbalance).



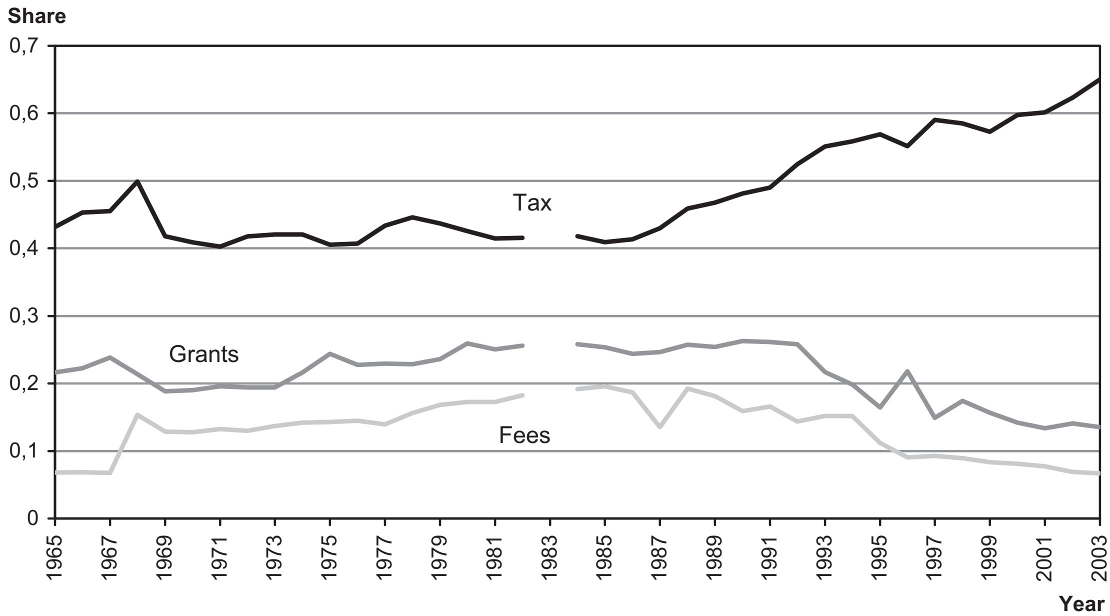
Source: Statistic Sweden's statistical database (statistikdatabas), available at www.scb.se.

Some notes on the path to present day situation for the municipalities

The municipal sector has grown enormously during the last half century. The really large increase started in the mid 1960s when the publicly provided child care sector was rapidly built out in the municipalities. Successively, the municipalities have become responsible for more services over the years, and, as noted earlier, some of these services are economically very large. To point out a few of these additions, in the early 1990s primary school and high school were decentralized from the state to the municipalities, in 1992 the municipalities became responsible for elderly care that the counties earlier had been responsible for (elderly care reform; "ÄDEL-reformen"), and the same thing happened with care for the mentally ill in 1995 (psychiatric care reform).

On the revenue side, the three main revenue sources have evolved a bit differently over time. Figure 3.19 shows tax revenues, grants and fees as shares of municipalities' total revenues for the years 1965–2003. As is clear from the figure, the respective shares were quite stable for many years in the beginning of the period; from 1965 and 20 years ahead in time fees constituted approximately 15–20 percent, grants approximately 25 percent and tax revenues approximately 45 percent of the total revenues. From 1985 and onwards there has however been a change since both the grants' share and the fees' share has decreased (to approximately 15 and 8 percent respectively) while the tax revenues' share has increased to approximately 65 percent. During the last two decades, own-generated tax revenues have thus become relatively more important for financing the municipalities' responsibilities.

Figure 3.19. Municipal tax revenues, intergovernmental grants and fees as shares of the municipalities total revenues.

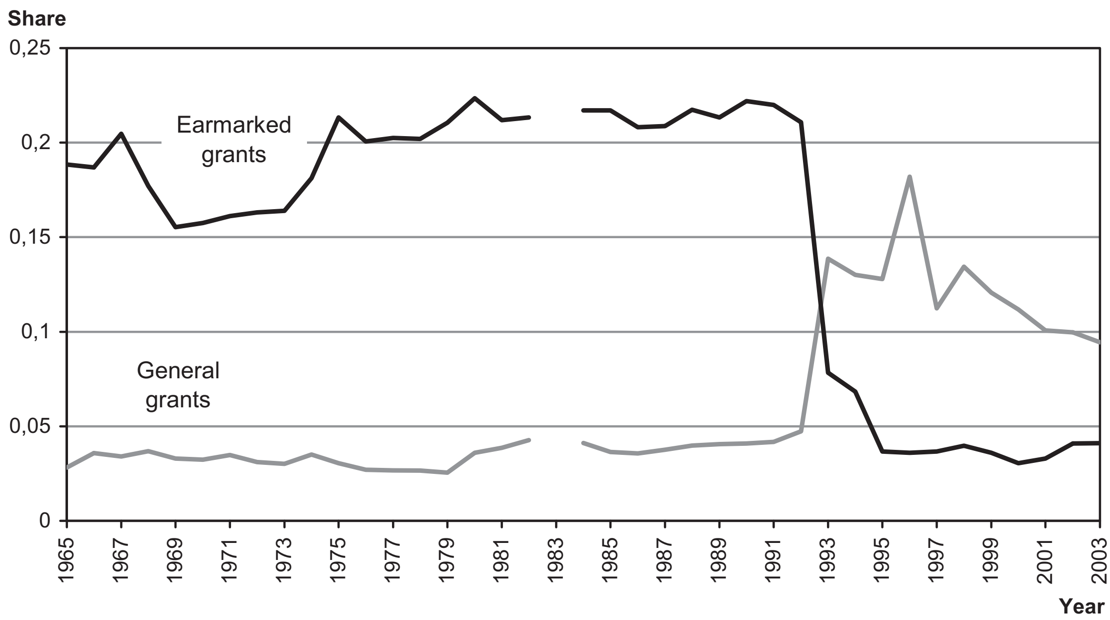


Source: Statistic Sweden: Kommunernas Finanser, annual volumes 1965–2003.

Regarding the intergovernmental grants system, there was a major reform in 1993. The largest change in the 1993 grant reform was that the majority of the earmarked grants were replaced with a general grant to the municipalities. This is clear from Figures 3.20 and 3.21. Figure 3.20 shows the different types of grants as share of the municipalities' total revenues. From 1965 to 1992 the earmarked grants made up approximately 20 percent of the municipalities' total revenues, while the corresponding figure for general grants was less than 5 percent for the whole period. This was altered by the grant reform, and from 1993 general grants constitute a larger part of total revenues than earmarked grants do; a little more than 10 percent for general grants compared to less than 5 percent for earmarked grants. During some years from 1993 and onwards, there was an economic squeeze in the Swedish economy, which, among other things, meant that the total grants supplied by the state to the municipalities decreased; this explains the decreased share overall after 1993. To get a clearer picture of the change in connection with the 1993 reform, Figure 8 shows the two types of grants as shares of total grants received. Before the reform, general grants constituted less than 20 percent of total grants, after the reform they constituted more than 80 percent.

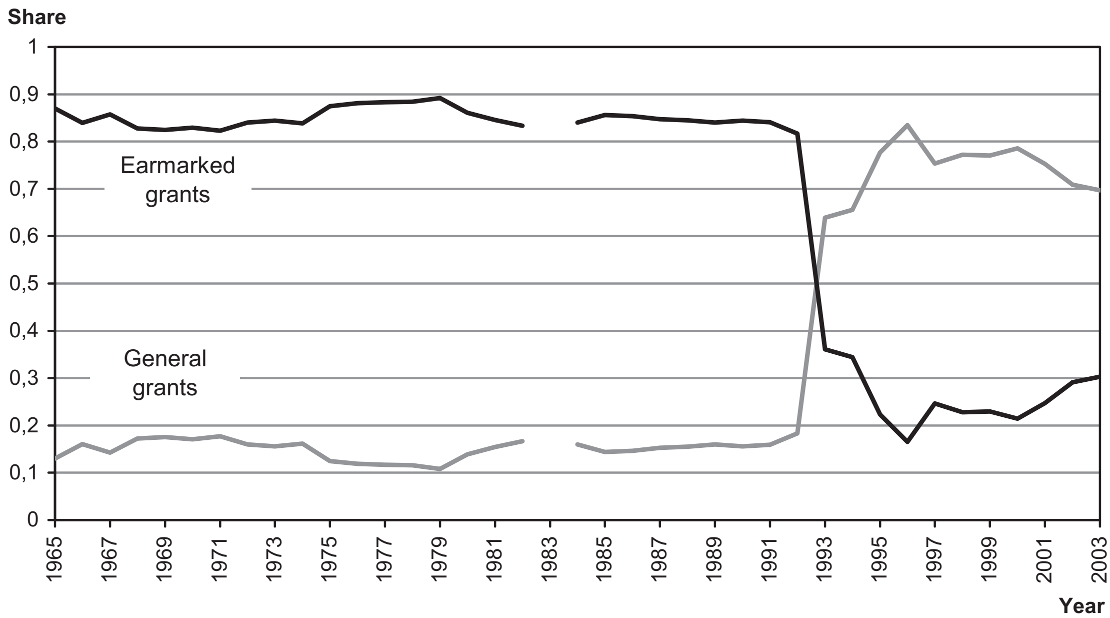
As a final note on intergovernmental grants, it can be worth mentioning that Sweden has had a long tradition of using discretionary grants. Between 1974 and 1992, there existed for example a grant program in which municipalities in financial distress could apply annually to the central government for financial assistance, and the central government decided discretionarily who to grant assistance at the end of each year. On average over this period, the central government spent an annual 282 million SEK (in 1991 prices) on this program. While less than 50 municipalities received such funds between 1975 and 1980, between 100 and 150 municipalities did so during the 1980s and until 1992. Similar programs existed in the 1990s. During the early 1990s, several of the Swedish local governments ran into severe economic problems manifested in large recurrent deficits. As a consequence, a large number of municipalities turned to the central government for financial relief. To handle their demands, the central government set up two temporary committees, the *Housing Delegation* (in 1998) and the *Local Authority Delegation* (in 1999). The *Housing Delegation* focused primarily on cases where the municipalities' financial problems were connected to a municipal housing company. The *Local Authority Delegation* was established after the central government realized that many municipalities would not meet the balanced budget requirement by the year 2000. The local governments concerned claimed that their inability to balance their budgets was due to external factors. Responding to such claims, the central government decided to establish a transfer program for municipalities where this was found to be true. Municipalities could apply for such funds and the Local Authority Delegation was appointed to prepare the cases and to propose which municipalities that were to be granted a positive response. The central government did, however, have the final decision.

Figure 3.20. Grants as share of the municipalities total revenues.



Source: Statistic Sweden: Kommunernas Finanser, annual volumes 1965–2003.

Figure 3.21. Different grants as share of total grant revenues.



Source: Statistic Sweden: Kommunernas Finanser, annual volumes 1965–2003.

3.3.3 Effects of local government reforms

This section will discuss some of the more important reforms that have affected the municipalities in Sweden during the last decades. The reforms have had effect on the number and size of the municipalities, the municipalities' responsibilities, the municipalities' revenue side, and the degree of competition that the municipalities face. A brief description of the reforms will be provided, as well as their effects.

Reforms affecting the number and size of the municipalities: Amalgamation reforms

One set of reforms have been related to the number and size of the municipalities. There have been two major boundary reforms in Sweden during the last half century; one in 1952, which reduced the number of municipalities from 2,498 in 1951 to 1,037 in 1952, and one spanning over the period 1962-1974, which decreased the number of municipalities from a little more than 1,000 in 1962 to 278 in 1974. In the reform process initiated in 1962, the amalgamation was expected to take place voluntarily among the municipalities (given the new borders that were determined centrally in 1963). By 1969, only 38 new municipalities had however been formed, which forced the central government to decide that the reform should be fully implemented by 1974. After 1969, the remaining merging of municipalities took place at two points in time; the first wave was done by the end of 1970, and the final wave by the end of 1973.

In the 1952 reform, the average population increased from approximately 1,500 to 4,000. In the later reform, the aim was to construct municipalities with no less than 8,000 inhabitants. The main motivation for the two reforms was to gain economic efficiency in the provision of social services (for example through economies of scale in services and administration), even though this motivation was more clearly spelled out in connection with the later reform.[21]

The main arguments in favor of larger local governments are hence related to economic efficiency. However, since efficiency in production is hard to measure in general, and perhaps even more so in the production of publicly provided welfare services, there do not exist, as far as I know, any reliable studies on Swedish data examining whether efficiency increases when the size of the municipalities increases. Something that is measurable is however economic growth. Larger units can take advantage of economies of scale, which in turn can lead to economic growth (see Niklas Hanes and Magnus Wikström, 2008, for a discussion of different channels in which amalgamations into larger units might

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[21] A good overview of the amalgamation reforms is provided in Jordahl and Liang (2010).

affect the growth rate). Even though the empirical literature examining this question is scarce as well, there do exist one study on Swedish data. Hanes and Wikström (2008) use the amalgamation reform in 1952 to examine if it had an impact on the population and income growth rates of the amalgamated municipalities. They examine the growth of treated and untreated municipalities after the reform had been enacted. They find mainly no effects. The only significant effect they find is on the population growth rate for initially very small municipalities.

A potential problem with amalgamations of municipalities into larger units is that it might create common pool problems. In the common pool problem, a municipality that are to join another municipality has an incentive to raise its per capita debt before the amalgamation, realizing that the larger, amalgamated, municipality will have a larger common pool of tax revenues that can be used for repaying the loans after the amalgamation is done (before the amalgamation, debt financed expenditures almost exclusively benefit the own municipality, while all debt will be shared by all municipalities involved in the amalgamation). The smaller a pre-reform municipality is relative to the amalgamated post-reform municipality, the higher is the municipality's incentive to free ride on the future common pool of taxes.

Björn Tyrefors (2009) examines the effects of the amalgamation reform that ended in 1974 on the municipalities' pre-reform behavior on raising per capita debt. He finds empirical support for incentive effects generated by the common pool problem; the stronger a municipality's incentive to free ride is, the more does it increase its per capita level of debt in the period preceding the amalgamation. Evaluated at the mean of the incentive to free ride, the effect is estimated to be approximately 17 percent of the initial level of debt. He also finds that the more time the municipalities have to raise debt before the amalgamation has to take place (i.e., whether they amalgamated in 1970 or 1973), the more they increase their debt. As noted by Tyrefors (2009), this type of pre-amalgamation behavior is counteracting the potential positive effects resulting from the amalgamation.

A test of the common pool problem is also conducted by Henrik Jordahl and Che-Yuan Liang (2010). They use data from the years before the 1952 reform, i.e., a period in which all municipalities knew with certainty if they were to be amalgamated with some other municipalities in 1952, and, if so, which municipalities they were to merge with. They find strong support for free-riding behavior. Their conservative estimates indicate that the common pool increased per capita debt by 52 percent of new debt issued by the municipalities in the common pools. Jordahl and Liang conclude that the risk of free-riding may inhibit voluntary amalgamations, and amalgamations that are decided by the central government may need to follow strict protocols to prevent efficiency losses resulting from opportunistic behavior.

An important downside of amalgamations of municipalities into larger units is also from a democratic point of view. While economics of scale and the existence of externalities speak in favor of large government units, accountability and a better possibility to tailor output to local needs and preferences (preference matching) speak for keeping down the size of each unit. Matz Dahlberg, Eva Mörk and Hanna Ågren (2009) examine the preference matching-argument. Using survey data from the 1960s, a period when it existed really small municipalities in Sweden, they find that the smaller the political jurisdiction is, the better is the match between local politicians' and their voters' preferences for local services. They also find that local politicians have better knowledge about their voters' preferences in small local governments. However, the jurisdictions must have less than approximately 5,000 inhabitants in order for the correspondence to be really close. The results in Dahlberg, Mörk and Ågren hence indicate that regardless of whether politicians implement their own preferred policy or the one preferred by the voters, it is only in fairly small political jurisdictions that voters' most preferred policy will be implemented. It could of course be the case that in larger municipalities, the politicians implement policies that are in accordance with the voters' preferences (and not with the politicians' own preferences), something that is assumed in the commonly used median voter model. When examining the role of politicians' and voters' preferences in determining actual policy (municipal spending on child care, schooling, social care and total municipal spending), Hanna Ågren (2005) does however find that politicians' preferences affect actual spending even after the voters' preferences have been controlled for.[22]

That the size of a municipality also might affect other dimensions of local democracy is evident from the analysis in Peder Nielsen (2003). He finds that amalgamations can have negative effects on local democracy; the larger the municipality is, the lower is the voters' political participation and the lower is their view on the legitimacy of democracy. The voters also feel a larger communion with the municipality the smaller the municipality is. Nielsen concludes that the optimal division, from a democratic point of view, is one with small municipalities with only one dominating urban area in each municipality.

[22] Swedish evidence that the politicians' own preferences matter is also provided in Svaleryd (2009), who finds that the degree of female participation in the municipal council affects the spending pattern, and Pettersson-Lidbom (2008), who finds evidence of a party effect on municipal tax and spending policy.

Reforms affecting the municipalities' responsibilities

During the last decades, there have been some reforms that have affected the municipalities' areas of responsibilities. Some of these are the decentralization of schools in the early 1990s, the decentralization of elderly care in 1992 (a switch from a responsibility for the counties to a responsibility for the municipalities), the decentralization of care for the mentally ill in 1995 (also a switch from a responsibility for the counties to a responsibility for the municipalities), and the centralization of social welfare services in 1998. Most of these reforms have not been evaluated. Here I will mainly discuss the decentralization of schools, which is a reform that has been evaluated. I will also briefly discuss the centralization of social welfare services.

Decentralization of responsibilities for schools

Before 1991, the Swedish school system was heavily centralized. There were strict central government regulations and controls, centrally employed teachers and a system of intergovernmental grants that were ear-marked for specific categories of school spending. The municipalities had little freedom to allocate expenditures on different items within the school system. The decentralization reform started in 1991, with the main change being that the municipalities could freely allocate their money across schools and items within schools. Thus, even though the grants that the municipalities received were still ear-marked for schools, the municipalities received much more freedom in how to spend the money. In 1993 the big change came; in connection with that year's grant reform the ear-marked grants turned into a general grant to the municipalities. From 1993, the municipalities can freely allocate resources over its responsibilities. Finally, in 1996, the wage setting for teachers were decentralized to the school level. Up until 1996, the wages had been set in central negotiations implemented nationwide. The decentralization process is well described in Björklund et al. (2005) and Ahlin and Mörk (2008).

In the 1990s, Sweden experienced an overall decline in education expenditures relative to GDP. Expenditures per student in compulsory schools, as share of GDP per capita, declined from 34 percent in 1991 to 24 percent in 1999 (see Anders Björklund, Melissa Clark, Per-Anders Edin, Peter Fredriksson and Alan Krueger, 2005). Björklund et al. (2005) also document a decrease in the teacher density in compulsory schools; from 1990/1991 to 1999/00 the median teacher/student ratio decreased from 9.1 to 7.4 percent. To what extent the decline is due to the recessing economy and to what extent it is due to the decentralization of schools is very hard to tell. It is however possible to say something about the distributional effects of the reform.

Åsa Ahlin and Eva Mörk (2008) examine the effects of the decentralization of schools on the allocation of school resources over municipalities. They find that the municipal tax base per capita (i.e., average taxable income) does not seem to matter more for the municipalities' per pupil spending or for their teacher/student ratio after the decentralization than before. They conclude that there is no evidence supporting the view that your residence municipality has become more important for determining the amount of school resources that you are treated with.

Björklund et al. (2005) and Peter Fredriksson and Björn Öckert (2008) examine how the decentralization affected the distribution of resources over students. They find that after the reform there is an upward trend in the 90/10 percentile ratio of the distribution of the teacher/student ratio. Decomposing the 90/10 ratio into a 90/50 ratio and a 50/10 ratio, they find that the widening of the distribution mainly have taken place in the bottom of the distribution. That is, after the decentralization of compulsory schools, the school resources (measured through the teacher/student ratio) have decreased the most among those students that were already treated with low resources (i.e., with a low teacher/student ratio). Fredriksson and Öckert (2008) find that, using the decentralization reform as the identifying variation, increases in the student/teacher ratio have a significant impact on student achievements. They conclude that their result on student achievements suggest that student performance deteriorated throughout the 1990s in Sweden as a result of the falling teacher/student ratios over the same period.

Centralization of social welfare spending

Before 1998, the municipalities were free to set their own benefit norms (there was no mandatory rule for the benefit levels, but general guidelines were provided by The National Board of Health and Welfare). This decentralized decision-making in the setting of welfare generosity led to a large variation in the benefit paid out. For the period 1990-1994, the mean benefits paid out per benefit month was 3,960 SEK, with a standard deviation of 600 SEK (and with a minimum of 2,000 and a maximum of 7,900 SEK) (all monetary variables are deflated to 1990 year values). There was also a significant variation in the benefit norms set by the municipalities. During the years 1991, 1992 and 1994, the benefit norm averaged 112, with minimum and maximum levels at 80 and 145 and with a standard deviation of 7.8.[23]

It was the great variation between the municipalities, in particular the tendency to set the levels below the recommendations of the Board, that finally led to the

[23] The norm is defined as the percentage of the basic amount and the figures presented are the unadjusted levels for a single individual.

introduction of a mandatory minimum level in 1998 (Matz Dahlberg and Karin Edmark, 2008). Dahlberg and Edmark also found that there was a race-to-the-bottom in the setting of welfare benefit levels before 1998 (see section 3.3.4 below), which also argues for a centralization of welfare assistance.

Reforms affecting the municipalities' revenue side

As mentioned earlier, there are three main revenue sources for the municipalities: income tax revenues, intergovernmental grants and user fees. There has in principle been no reforms regarding the local income tax, which for decades has been the completely dominating local tax (and today is the only local tax). There have however been important grants and fee reforms.

Grant reforms

Since the first general grant system was imposed in Sweden in 1966, there has been several reformations of the system. Several of the changes have been related to the tax equalization formula, mainly regarding the degree of compensation (which is 0.95 today; c.f. equation (1)) and to the reference level (which today is 115 percent of the average tax base; c.f. Equation (1)). Given the size of the tax equalizing grants in Sweden and the incentive effects they (theoretically) have on the municipalities' tax and growth-enhancing behavior, it is unfortunate that there does not exist any empirical studies examining the effects these grants have on municipal behavior.

The perhaps most dramatic grant reform took place in 1993. One of the major changes in that reform was a switch from mainly targeted (earmarked) grants to mainly general grants (c.f. Figures 3.20 and 3.21). Using data for the period 1988–1995, Pål Bergström, Matz Dahlberg and Eva Mörk (2004) utilize the grant reform in 1993 to identify which type of grants that have the largest effects on municipal employment. They find a larger municipal employment elasticity with respect to grants before the reform, which they interpret as evidence that general grants have lower employment effects than specific ones. Similar results are found in Ahlin and Mörk (2008). Using the same grant reform, they find that the less targeted the grants are the lower is the teacher/student ratio. They do however not find any statistically significant effects of the reform on per pupil school-spending.

From 1993 until today, the major part of the intergovernmental grants in Sweden are general grants with no strings attached. An interesting question is therefore what effects general grants have on municipal tax and spending decisions. Matz Dahlberg, Eva Mörk, Jørn Rattsø and Hanna Ågren (2008) investigate the causal effect of general intergovernmental grants on local public spending and taxes. Using a discontinuity in the Swedish grant system to solve the endogeneity of grants, they find evidence of crowding-in, where federal grants are shifted to more local spending, but not to reduced local taxes. They cannot reject the null hypothesis that an increase in general grants with 1 SEK/capita increases local spending with 1 SEK/capita. In other words, they cannot reject the null hypothesis of full crowding-in of general grants.

Fee reforms

During the last decades there have been a couple of reforms that have imposed a cap on user fees that the municipalities can set; the maximum fee (maxtaxa) within child care and the maximum fee within elderly care. These kinds of reforms do probably not have that large effects on the municipalities' budget (recall from Table 3.8 that user fees on average only stood for 6 percent of the municipalities' total revenues), but they do of course affect the local self-government. What is more important is that they might have large impacts on a single individual's budget and behavior (which was the main idea with the child care fee reform). While the maximum fee reform within elderly care has, as far as I know, not been evaluated, the fee reform within child care has.

Before the child care fee reform was implemented in 2002, the user fees varied considerably over the municipalities and constituted a fairly large share of the households' net income. After the reform the price on publicly provided child care was considerably reduced and the variation over municipalities had almost gone to zero (Daniela Lundin, Eva Mörk and Björn Öckert, 2008).

The child care reform implied that similar households experienced different price changes depending on in which municipality they resided. Lundin, Mörk and Öckert (2008) use the variation in price changes that the reform generated to estimate the effect of the price of childcare on mothers' labor supply in a difference-in-differences regression matching framework. They find no effects on mothers' labor supply; their estimates are very precise and close to zero.

Should the central government impose caps on user fees that the municipalities can charge? In the end there is a trade-off where one has to value the costs in terms reduced local self-government and a reduction in the municipalities' possibilities to raise revenues against the benefits resulting from the cap (like effects coming from a change in individual behavior, e.g. increased labor supply).

Reforms affecting local competition: Privatization reforms

For a long time the public sector was the monopolist supplier of welfare services. During the last two decades this has changed quite dramatically. Several of the services that the municipalities earlier were the only providers of, now have private providers as well. We have for example seen privatization reforms within the school sector and within the sectors for elderly care, social care and child care. There has been a marked increase in market solutions and individual choice within these areas and, as a consequence, competition has increased. For most of these sectors we do not yet know the effects of the increased competition. The exception is the school sector for which recent research provide us with several answers of the effects of the privatization reform.

In 1992, a radical change in the school system appeared in Sweden. From that date, the municipalities were required to fund independent, privately run, schools. This led to a sharp increase in the number of pupils in private schools. In 1992, less than one percent of the pupils attended a private school in ninth grade. In 2003, the corresponding figure was five percent. In 2003, private schools with ninth grade pupils existed in 93 out of 2003 municipalities. Among these 93 municipalities, the average private school share was nine percent, but the variation was quite large with one municipality having a share of almost 40 percent of private schools.[24] Since the start in 1992, the students have been completely free to choose between the two types of schools. The reform hence led to an increase in the competition that the municipalities face in the provision of education. What effects have this increased competition had on the quality of schooling?

From a theoretical point of view, increased possibilities to make individual choices between private and public schools can affect the quality of schooling via two channels. Either because private schools are better than public schools (average school performance would then increase through the mere reallocation of pupils from the inefficient public sector to the more efficient private sector) or because the competition between schools for pupils, teachers and resources induced by increased individual choice improve overall school quality. In the first channel, increased competition only benefits pupils in private schools. In the second channel, all pupils benefit from increased competition (both those in private schools and those in public schools).

There are several papers empirically examining the effects of increased school competition on school quality (measured by student performance through grades

[24] The figures come from Böhlmark and Lindahl (2007, 2008), where also a more detailed description of the reform and the development over time can be found.

and test results); see Åsa Ahlin (2003), Mikael Sandström and Fredrik Bergström (2005), Björklund et al. (2005), and Anders Böhlmark and Mikael Lindahl (2007, 2008). The most comprehensive and detailed of these studies are those by Böhlmark and Lindahl (2007, 2008). Investigating the effects of increased school competition by using a large register data set on pupils grading from compulsory school in 1988–2003, Böhlmark and Lindahl find in their 2007 paper that a ten percentage point increase in the private school share lead to an increase in the average grade by one percentile rank point. Is the positive effect on school quality from the introduction of school choice driven by better and more efficient private schools or by increased competition between schools? By using variation in school choice among siblings, Böhlmark and Lindahl (2007) are able to disentangle the role played by the two channels. They find that approximately 90 percent of the effect is driven by increased competition. The increase in private schools and the associated increase in individual school choice hence seem to benefit all pupils (i.e., pupils in both private and public schools) via an effect from competition that forces all schools to improve. This positive effect from competition seems however to be short-lived. In their 2008 paper, Böhlmark and Lindahl find very little support for a lasting effect of their estimated positive compulsory school effect on an improved performance in high school for the same individuals. Also, they do not find any effects of the increased competition at the compulsory level on subsequent university attainment or years of schooling. Böhlmark and Lindahl (2008) conclude that the positive first-order effect, which they consider to be small, vanishes over time and do not seem to lead to lasting positive effects.

Even though school competition might lead to increased productivity that gain all students, critics of a privatization of schools are worried that it might induce segregation between the two types of schools (by e.g. ability, income or ethnic background) and can lead to a worse situation for those pupils that remain in public schools (for example through a lower quality of the peer group and a migration of good teachers from public to private schools). Another issue of concern is the effects of privatization on overall costs in the school sector. Böhlmark and Lindahl (2007) examine these issues and find that there are some segregation effects (children with well-educated parents and/or children with an immigrant background have a higher probability of choosing a private school) and some cost effects (an increase in the private school share by ten percentage points lead to approximately two percent higher municipal school costs on average).

To sum up the results, it hence seems like there is a small positive short-run effect of competition on student achievements at the compulsory level. These effects do however not last into positive achievement effects at the high school level or to more years of schooling. At the same time there is some sorting on background characteristics going on between the two types of schools and the overall school costs for the municipalities are increased.

3.3.4 Effects of the decentralized system in Sweden

In the former section we saw how different reforms have affected the municipalities. But it is of course also highly likely that (different degrees of) decentralization per se will affect the economy; it might for example affect outcomes such as economic growth, economic stability, public sector efficiency, equity, and income distribution. Even though it would be beneficial and important for policy making to have information about these effects, our knowledge of these issues for Sweden is very limited. As far as I know, we know nothing about the effects of decentralization on economic growth, stability, and income distribution. One reason for this lack of knowledge is that it is genuinely hard to know the counterfactual, and hence difficult to get a trustworthy estimate of the coefficient of interest. We do however know some things about the effects of decentralization in Sweden on different efficiency and equity outcomes.

Strategic interactions and competition

In a decentralized system, strategic interactions and competition among the municipalities might arise. This can for example be in the form of tax competition, where the municipalities use the local income tax to compete with each other to attract rich, mobile households. It can also be in the form of yardstick competition, where voters use information about the efficiency in the supply of services in some reference municipalities (for example neighboring municipalities), to get a measure on how well the own local decision-makers are doing. If politicians know about this, this might enhance efficiency. While the theory of tax competition predicts that the tax rate in a decentralized setting will be lower than the social optimum, the yardstick competition theory in general predicts increased efficiency of the political system through better informed voters. In the same vein as tax competition there can also be welfare competition, where the municipalities use the benefit norm to compete with each other to avoid attracting poor, welfare prone households. In the presence of welfare competition, the generosity in the welfare system, measured by the benefit norm, will be lower than what is socially optimal.

Karin Edmark and Hanna Ågren (2008) examine if there is any strategic tax setting in Swedish municipalities. Their analysis provides evidence of spatial dependence in the tax rates among Swedish municipalities; a tax cut of on average 1 percentage point in a neighboring municipality is correlated with a decrease of about 0.74 percentage points in own taxes. Using an equalization grant reform and different political variables (such as election dates and political strength in the municipal council), Edmark and Ågren also try to sort out if the observed strategic tax setting is driven by tax competition or yardstick competition. They find evidence for tax competition but no evidence for yardstick competition.

Regarding welfare competition, Matz Dahlberg and Karin Edmark (2008) investigate whether there existed such competition in Sweden before the setting of the benefit level was centralized in Sweden in 1998. They do this by examining how local governments react on the welfare benefit levels in neighboring jurisdictions when setting their own benefit levels. They use a policy intervention as an instrument to solve the simultaneity problem that arises from the welfare game that the local governments play; a centrally geared placement of a highly welfare prone group (refugees) among Swedish municipalities. Dahlberg and Edmark find a significant and positive effect from the setting of welfare benefit levels in neighboring municipalities on the setting of the welfare benefit level in a given municipality. The point estimates indicate that if the neighboring municipalities decrease their welfare benefit level with 100 SEK, a municipality decreases its benefit level with approximately 41 SEK. The estimates for neighbors' benefit level hence provide indications of strategic interactions among the local governments in the setting of welfare benefit levels, implying that there exists a "race-to-the-bottom".

Soft budget constraints

A potential problem with decentralized decision-making is the risk that local governments engage in strategic behavior to attract financial resources from the central government. Decentralization can lead to soft budget constraints at the local level. The local budget constraint defines the total amount of resources, collected from local sources and received as transfers from other governments, expected to be available to finance local public policies during a fiscal year. The budget constraint is soft if local governments perceive that the central government lacks the ability or will to keep them to fixed budget constraints. That is, if the local governments expect to receive financial help from the central government (i.e., to receive more grants than what was determined ex ante) in case of future financial problems and that this expectation affects their financial behavior, we have the problem of soft budget constraints at the local level.

The problem with soft budget constraints can materialize in two different set-ups. Either they can materialize when there exist grants to the municipalities with financial problems but where there are no clear rules for how and when the grants shall be distributed and when the central government can discretionary decide how to distribute the grants (as was the case with the extra grants that existed in Sweden until 1992; see section 3.3.2). Or they can materialize if there is an expectation that additional grant programs will be installed in case of financial problems at the local level (which for example was the case with the set-up of the Housing Delegation and the Local Authority Delegation in Sweden in the wake of the financial problems during the 1990s; see section 3.3.2).

Using the discretionary grant program that existed in Sweden between 1974 and 1992, Per Pettersson-Lidbom examines if there are any soft budget constraints among Swedish municipalities. He examines whether the municipalities' expectations to receive extra grants in the future (i.e., future financial help from the central government) affects their financial behavior today. This is the important question for the presence of soft budget constraints. The grant program he uses is well suited for testing for soft budget constraints. It is a program with no strict rules and where the central government has the power to decide itself how the grants shall be distributed over the municipalities (if there were strict rules that were followed by an independent authority there would not exist any uncertainty whether a municipality should receive extra grants or not). In addition, the program was expected to be used for municipalities with financial problems. The main result in his study is that the municipalities' expectations about future financial help leads to higher municipal debt today. The estimated effect is that, on average, a municipality that goes from a probability of zero to a probability of one of knowing that they will receive a future bailout increases its debt by approximately 20 percent. He further finds that the municipalities' expectations about a future bailout only affect their expenditures; their revenues are not affected by the soft budget constraint. Swedish municipalities hence seem to have been involved in strategic behavior to extract extra money from the central government. That is, the soft budget constraint is, or at least has been, a real problem in Sweden.

It can also be mentioned that discretionary grant programs like those that have been in use in Sweden for large periods of time might have other effects as well. They can for example be used by the central government for strategic reasons. Dahlberg and Johansson (2001) do for example find support for the hypothesis that the incumbent government in Sweden used a discretionary grant program for ecological sustainable investments in the municipalities in order to win votes. In particular, they find strong support for the hypothesis that the incumbent government distributes transfers to regions where there are many swing voters.

Adapting to local conditions

The main argument for decentralization is perhaps that it is easier for local decision-makers to tailor publicly provided services to local needs, local preferences and local cost conditions. As we saw earlier it takes really small municipalities to get a perfect match between voters' and local politicians' preferences. It might of course still be the case that the locally provided services are better matched to local conditions than what would have been the case under central decision-making for the same services, but that we do not know anything about. Another take on this is that too much variation over municipalities and individuals for certain services is not desirable from society's point of view. As we saw earlier, the large variation in welfare benefit norms over municipalities was the main argument for the centralization of the norm in 1998. Likewise, research on decentralization of schools in Sweden indicate that decentralization might have led to an, from society's point of view, undesirable large variation over students in school resources (see former section). Decentralization of schools might hence lead to decreased equity.

3.3.5 Potential reforms in Sweden and some comments on the Swedish system

It is of course possible to come up with many types of changes or reforms regarding the state-local relationship in Sweden, but I think there are two reforms that might be especially urgent to considered.

One reform concerns centralization of schools. Sweden is one of the most decentralized countries in the world, where several welfare services are decentralized to the municipal level. One might ask whether all types of welfare services are suitable to decentralize. It is not obvious that it is a good idea, for example, to decentralize primary schools and welfare. Research has shown that when social welfare (welfare assistance) was decentralized in Sweden, it lead to welfare competition among the municipalities and a, from society's point of view, sub-optimal level in the welfare generosity (there was a "race to the bottom"). In 1998, social welfare was centralized in the sense that the generosity in the welfare system became centrally determined. Likewise, research on decentralization of schools in Sweden indicate that decentralization might lead to an, from society's point of view, undesirable large variation over students in school resources (measured, e.g., through the teacher/student ratio). Thus, from an equity perspective, a decentralized school system might not be desirable. Some centralization of schools might be called for.

The second reform is related to the urge to decrease potential negative effects of business cycle swings on specific municipal services. Since the major part of the municipalities' revenues comes from a local income tax, where the local tax base only consists of labor income, the municipalities' revenues are sensitive to business cycle swings. In addition, expenditures within certain areas are also sensitive to changes in the business cycle, like welfare assistance. Taken together, this implies that the risk for short-term fluctuations in welfare services such as education, child care and elderly care is considerable. This is unfortunate since these are services that should be supplied on a long-term and stable basis. A reform that decreases the swings in services such as education, child care and elderly care could be of considerable importance. Such a reform could have ingredients like centralizing some services (e.g., centralizing primary schools), tying grants to the general macro economy, so that they adjust with swings in the business cycle, or relaxing the municipalities' balanced budget requirement, which opens up the possibility for the municipalities to conduct business cycle adjustments themselves by building up funds in good times to be used in bad times.

Apart from these two reforms, there are some comments on the Swedish system that might be worth considering:

- Sweden has a long history of discretionary grants. Since research has shown that these types of grants create soft budget constraints at the local level and invites to strategic behavior at the central level in its allocation, discretionary grants should be avoided in the future.

- There is a need to evaluate the tax equalization system in Sweden. Given the size of the tax equalizing grants in Sweden and the incentive effects they might have on the municipalities' tax and growth-enhancing behavior, it is unfortunate that there does not exist any empirical studies examining the effects these grants have on municipal behavior.

- There is a need to find out what effects general grants have in different phases of the business cycle. In the recent recession, it was clear that it would have been beneficial if the decision-makers had known about what effects general grants have in deep recessions.

- There is a need to examine the effects from different types of grants on the municipal development at large (income growth, population growth and employment growth). We know nothing about these effects.

- The political decision-makers should implement reforms in such a way that trustworthy evaluations of the reforms are facilitated. Sweden has a sad record in this respect.

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Chapter 4

Public Services at the Local Level – The Finnish Way

Antti Moisio – Heikki A. Loikkanen – Lasse Oulasvirta

4.1 Introduction

Finland is by population a small Nordic country with a challenging environment for arranging local public services and fiscal equalisation. The country is large in area and therefore mostly sparsely populated. Despite the rapid urbanisation in recent decades, around one third of the 5.3 million inhabitants still live in rural areas. Also the age structure of the population varies considerably between municipalities. As a result, the service needs and the operating environment as well as the ability to raise own source revenues differs much between areas in Finland. Despite these obstacles, Finland has been able to build an extensive public service system so that the country is considered to be a "Nordic welfare state".

Although Finland clearly belongs to the Nordic countries' group with regards to its high degree of decentralisation, the Finnish case differs from the other Nordics in many ways. The most obvious difference is that in Finland public administration is organised by only two tiers of government, the central government and the municipalities, whereas in Sweden, Norway and Denmark the local government consist of municipalities and intermediate government level.

Due to the intense decentralisation and a single tier of local government, the Finnish municipalities bear a heavy burden of tasks. Municipalities are responsible for providing social welfare and health care services as well as most education and culture services. In addition, municipalities provide the basic environment and technical infrastructure services. The fact that nearly half of the Finnish municipalities have population of less than 5000 inhabitants means that many municipalities are too small to organise all these services alone. As an answer to the economies of scale problem, the Finnish solution has been to organise the most demanding tasks through cooperative arrangements. At the beginning of 2010, there were 326 municipalities and 226 joint authorities.

Finnish municipalities are self-governing entities by constitution. But despite their self-governing status, the provision of many public services has been delegated from central government to the municipal sector in Finland. And because a number of municipal tasks are regulated in detail by central government legislation, the municipalities may have little or no room to maneuver independently. In practice, it is often only the wealthiest municipalities that can afford to provide services above the set standards.

Due to the many tasks assigned to municipalities, the overall economic importance of the municipal sector is considerable. Municipality spending as share of GDP is around 18% and municipalities employ roughly 20% of the total Finnish workforce.

Municipal finances are based on own source revenues and grants from central government. On average, grants cover some 20 per cent of the total municipal revenues. The main source of revenue is the municipal income tax that makes up 41 percent of all revenues. Municipalities are the sole receivers of property taxes but the share of property taxes is only 2.5 per cent of revenues. Municipalities also receive a share of corporate tax revenues. The rest of the municipal revenues consist of user fees and sales incomes. Due to big differences in size between municipalities, the small rural municipalities rely on the grant system and equalisation. In 2009, grants covered more than 50 percent of all revenues in every fourth municipality.

The rapidly aging population and domestic migration is threatening to erode the tax bases and increase the service needs in Finnish municipalities. To rescue the local service system, the central government has launched various new policy programmes. These include municipal mergers, enhanced cooperation and productivity programmes. The political discussion about further measures has started and the new government will have to make decisions on these after the parliamentary elections in 2011.

The main purpose of this paper is to describe the organisation, tasks and financing of the Finnish local government. The description concentrates on welfare, health and education tasks and their financing. The other municipal tasks are mentioned only briefly. When possible, we refer to the latest available research results. Although the most important aim is to give the reader a general picture of Finnish local government, some assessment of the present system is also provided.

This paper is organised as follows. Section two describes the local government organisation, tasks and finance. Section four compares Finnish local government to other Nordic countries and some OECD countries. Section 5 concludes the paper with discussion on the present stage and future prospects of Finnish local public sector.

4.2 Finnish local government in short

Historical perspective

After Finland gained its independence in 1917, a provision on local self-government was added to the first Finnish Constitution in 1919 and universal and equal voting rights were introduced for municipal elections. The municipal assemblies of rural municipalities were replaced by councils. In towns, the councils that were elected in general elections got the highest decision making power displacing the old bodies of magistrates and aldermen. (Heuru 2003).

In 1932 provisions on inter-municipal co-operative organisations and joint municipal authorities were added to municipal legislation. This was a significant decision because since then Finland has kept the model of a single tier local government system. In 1949 the municipal legislation was updated so that towns and rural municipalities were brought together under one Local Government Act.

Since the end of the 1950's many new statutory obligations have been assigned to municipalities. As a result of this process, all basic social and health services are today performed by municipalities or by joint municipal authorities. In addition, all education except universities belong to municipal tasks. The enlargement of local government tasks was especially rapid in the 1970's and 1980's.

The growth of municipal sector was halted in the beginning of 1990's. Between 1990 and 1994 Finland faced a severe economic slump during which GDP fell cumulatively by more than 10 per cent. The recession caused difficulties in municipalities. As the unemployment rate rose from 4 per cent at the end of the 1980s to over 16 per cent in 1994, the tax revenues of municipalities decreased sharply. Municipalities reacted to the decreasing income tax base by raising tax rates, increasing fees for health care and social welfare services, borrowing, by holding back investments and restraining the health care and social welfare expenditures. Municipal salary expenditures were reduced by discharging part-time labour and also by laying off full-time employees.

The deep economic recession added momentum to grant system reform in 1993, but the reform actually culminated a preparation that had begun already in the

1980's. By the beginning of 1990's it was already widely accepted that further enlargement of local public services had become unwanted. The reform meant a change from a pure matching grant system to a formula based block grants system. In addition, the new Local Government Act was enacted in 1995. These reforms gave municipalities more independence to decide their own matters. The economic situation started to improve from 1994, but the municipal finances were still tight for many years partly due to grant reductions during the years 1993–1998.

Organisation

At the beginning of 2010 there are 342 municipalities. In 1945 there were 558 municipalities and 460 in 1990. The reduction in the number of municipalities was based on voluntary mergers. Since the 1990's the central government has tried to step up the voluntary merger process with supplementary merger grants and lately by setting minimum population bases for some services.

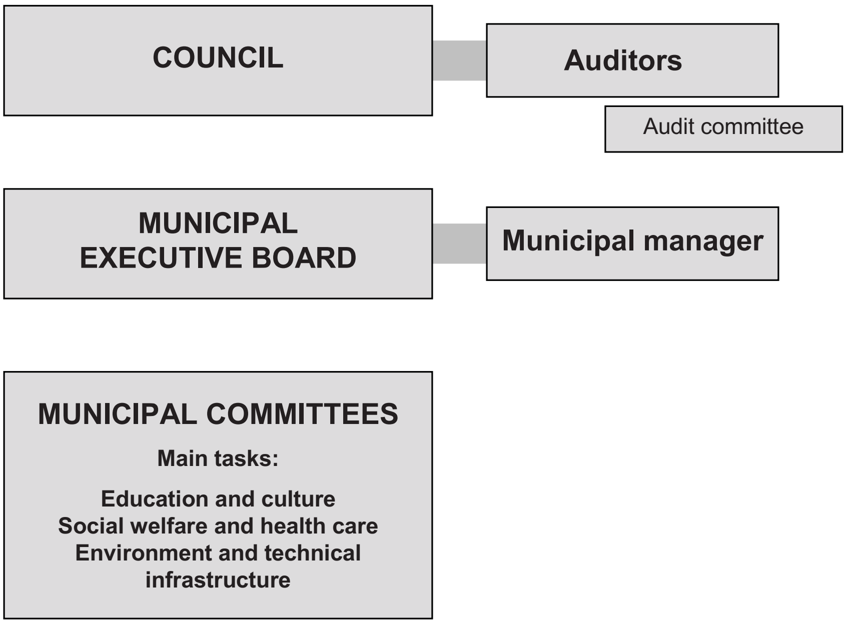
Although municipalities can organise their administration relatively freely, the Local Government Act stipulates that each municipality must have a municipal council, a municipal board, an auditing committee, and a committee for organising elections. A municipality must also have a municipal manager, a civil servant, elected by the municipal council. The municipal manager is not a member of the council.

A municipal council is elected by the residents in a secret ballot for four year terms. The number of councillors is proportional to the population of the municipality and may vary from 17 to 85. As in all Finnish elections, votes are given to individuals rather than party lists. The municipal council must decide upon strategic and financial outlines and on the main objectives for different municipal activities. Councils can set up committees that handle functions of a permanent character, for example, social and health care services, education, urban planning and environment and cultural and leisure services. The committee members are usually local politicians but not necessary members of the council.

The members of the municipal board are chosen by the municipal council. The composition of the municipal board is based on the political makeup of the council: the parties represented in the council get seats in the municipal board according to their share of council seats. Thus, there is no real opposition in local politics and municipal elections do not typically cause major changes in local politics. The municipal board is responsible for municipal administration and financial management. It prepares matters to be decided by the council, executes the decisions and ensures their legality. Municipal boards hold a strong administrative position, because the most important matters prepared for the council are politically agreed in advance in the board.

The municipal manager is a civil servant who works under the municipal board as the head of municipal administration, financial management and other functions. This arrangement differs from most other European countries, where municipality managers are (directly or by councils) elected mayors, who are also chairs of local councils or boards or both.[1] In Finland, the municipality managers hold their position either for a fixed term or the positions are permanent. The choices of city managers do not necessarily take place close to local elections. The situation is however slightly different for the biggest cities. City managers (called mayors and deputy mayors) in the biggest cities are often de facto politicians, who have risen up from city councils or national politics to this position elected by local councils.

Figure 4.1. Main bodies of Finnish municipal organisation



Source: Association of Finnish Local and Regional Authorities (modified)

Decision-making

Municipal councils approve the annual budget. In addition, the councils approve the financial plan for at least the next three years. The emphasis of the budget is on performance budgeting, i.e. the council sets operational goals that the

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[1] According to the Local Government Act, it is also possible to establish an elected mayor post in Finland but this possibility has been used so far only by couple of municipalities.

committees and agencies must realise with the budget money allowed by the council.[2]

Some of the budgetary power can be delegated to lower level committees in the municipality. The committees that work under the council are responsible for municipal service departments (such as health and welfare, education etc…). The decentralised power within the municipal organisation is mainly based on net budgeting and frame budgeting principles (Kallio et al. 2005).

The municipal board prepares the proposals for the council and executes the decisions of the council. It is often the case that the municipal board together with the leading civil servants have the real budget power, although the council has the ultimate formal power (Kallio et al. 2005).

The budgetary power of the municipalities is somewhat limited by the Local Government Act. By law, the municipalities are obliged to draw up a plan for covering accumulated deficits[3]. The aim of this rule is to prevent the accumulation of deficits on municipal balance sheets and to avoid economic imbalance in municipalities. However, there are no sanctions for not following the plan.

The municipal auditing consists of two elements: a professional external auditing and performance auditing. The external auditors concentrate on the municipal financial statements and annual reports. The external auditors are certified public sector auditors and each municipality selects the auditing company through a public tendering process.[4] The performance auditing is executed by special auditing committee and its role is mainly in "value for money auditing". The obligatory auditing committee is appointed by the council for the duration of its term of office. In addition to the performance auditing accomplished by the obligatory auditing committee, some of the bigger cities have established internal

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[2] According to the Local Government Act the budget must include performance objectives and appropriations needed to fulfil these performance objectives.

[3] The deficit concept defined in the Local Government Act has been criticised for not giving an accurate picture of the real balance of municipal economy. According to this critic, the mere profit and loss statement may give too narrow view of the municipality's real economic balance. When considering economic balance, one should also take into consideration that municipalities with growing populations need surplus in order to finance investments, whereas in a shrinking municipality with minor investment needs, a deficit is not necessarily a sign of economic imbalance. In addition, the imbalance of the local government sector may be a signal that central government policy towards municipalities is out of balance and that obligatory municipal tasks stipulated by legislation are not in concord with municipalities' own income sources and State grants (Kärki et al. 2006).

[4] The external auditing process was established in connection with the 1993 grant reform. The external auditors replaced the central government monitoring that was necessary during the matching grants system.

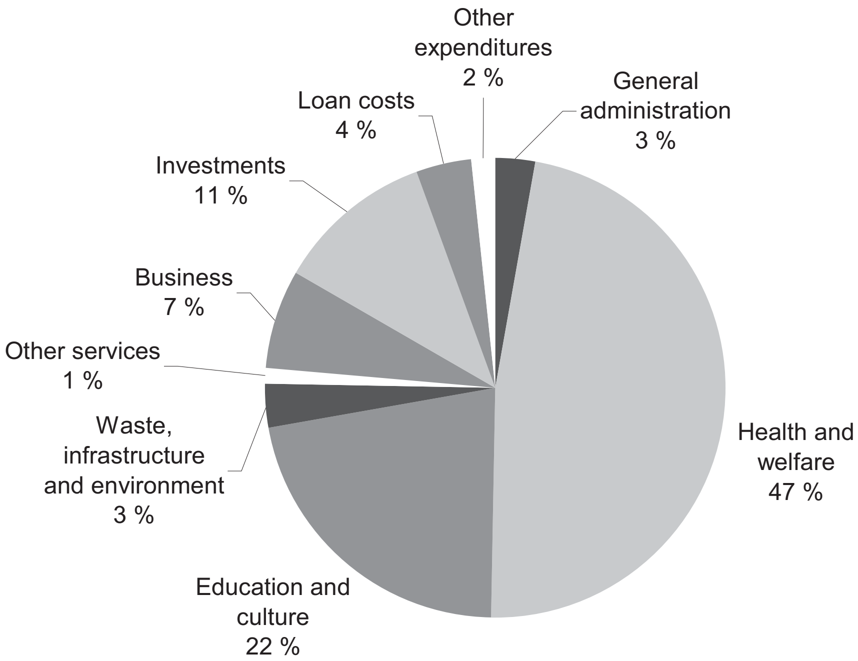
auditing (internal audit units, usually with 1–5 internal auditors) serving the top management.

Tasks

Finnish municipalities are self-governing entities by constitution. This means that central government cannot assign new responsibilities to municipalities without first passing legislation to this effect. Despite this, the decentralisation of public services to local level has been very extensive. Municipalities are responsible for supplying all health and welfare services and all education services except for university education. These services comprise about 70 per cent of the municipal sector expenditures (Figure 4.2). In addition to these main services, municipalities and joint authorities run or organise a wide variety of other tasks such as cultural, environmental, leisure and planning services (see Table 4.1 for a list of the most important service categories).

In the Finnish context, those tasks related to providing (mostly also producing) merit goods like health, social and education services are the most important economic activities carried out by municipalities. In providing these services, municipalities act as the agents of central government (=principal) whereas the national parliament makes key decisions on these services. The most important locally controlled task performed by local governments is the provision of local public goods in their area. A key function in this respect is that municipalities are responsible for land use planning in their area. Local policies in land use affect settlement structures, location of businesses, residential areas and transportation. These choices affect productivity in the private sector (World Bank 2009) and the efficiency of public service provision because merit goods (health units, schools etc) and other services need spatial networks of units. Land use decisions (zoning) affect the nature of these networks and costs of provision.

Figure 4.2. Expenditures in municipalities and joint municipal authorities in 2008



Source: Association of Finnish Local and Regional Authorities

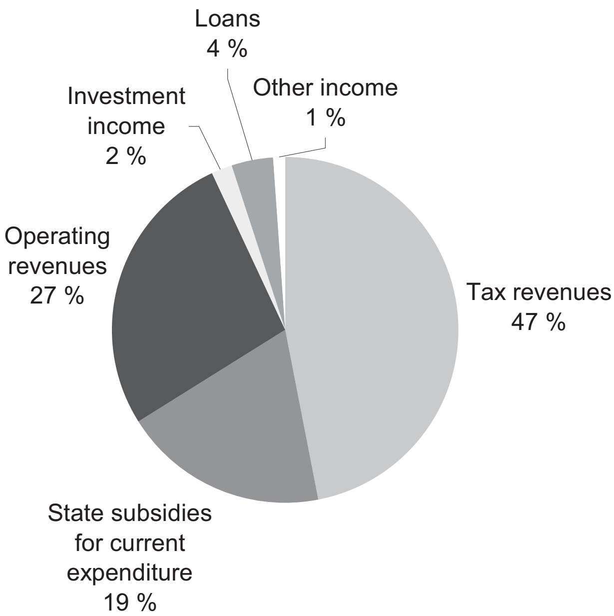
Table4.1. Services that are organised by municipalities

Education
Comprehensive and upper secondary schools
Vocational institutes
Polytechnics
Adult education
Basic music and art education
Culture
Libraries
Other culture services (theatres, museums, orchestras…)
Health care
Primary care
Specialist care
Dental care
Environmental health care (health protection)
Welfare
Child day-care
Elderly care
Care for disabled and the 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

Municipal finances

Municipal finances are based on own source revenues and a single block grant from the central government. Municipalities are also free to borrow for investment purposes and to finance running expenditures, although the latter is quite rare. Municipalities are obliged to draw up a plan for covering accumulated deficits. The aim of this rule is to prevent the accumulation of deficits on municipal balance sheets and to avoid economic imbalance in municipalities. Figure 4.3 shows how the municipal finances were constructed in 2009.

Figure 4.3. Total municipal sector income (2009 estimate)



Source: Association of Finnish Local and Regional Authorities

The main source of municipal revenue is the municipal income tax[5] revenue that makes up 47 per cent of all revenues. Municipal income tax is a flat rate tax, although central government policy for tax allowances for persons with low incomes has made the local tax more like a progressive tax. Hence, the local income tax base is determined by the central government but municipalities have full control over the rate.

[5] In Finland the dual income tax (DIT) system is applied (adopted in 1993), which divides personal income into two components: **capital income** (which includes dividend income, interest receipts, realised capital gains and rental income) is taxed at a flat rate of 28%; and **earned income** (which includes wages, salaries, pensions and social security benefits) is subject to central government income tax at progressive rates and to municipal and church taxes at proportional rates. In addition, there are social security contributions.

Municipalities are the sole receivers of the property taxes but the share of property taxes of total municipal revenues is only 2.5 per cent. Compared to income taxation, municipalities have little discretion over property tax rates as maximum and minimum rates are legislated by the central government.

Municipalities also receive a share (22 percent since 2005) of the state corporate tax revenue. For companies with activity in several municipalities the tax is distributed according to the municipalities' share of the company's employment. As part of the central government fiscal stimulus package, the municipal share was temporarily increased to 32 percent from 2009 to 2011. The high volatility of corporate income tax revenues is often claimed to cause problems because of difficulties to predict the revenues and because windfall gains may lead to higher expenditure that is difficult to reverse. Municipalities have strongly opposed all proposals to drop the corporate tax revenue from the municipalities' revenues menu, because of concerns that municipalities would not be fully compensated by higher state grants.

The block grant is defined using formulae. The formulas used are based on variables that measure service need and cost differences in the municipalities. The revenue equalisation is organised separately, but block grant and revenue equalisation are united in the payments phase. Revenue equalisation is based on a municipality-specific calculation of the tax revenues that the municipalities could raise, if they used the country average tax rates. The revenue equalisation system is to guarantee all municipalities 91.86 per cent of the average per capita calculatory tax revenues. The municipalities whose calculatory tax revenue is below this threshold receive the difference as a supplement to their block grants. The municipalities whose calculatory tax revenue is above the threshold, must pay 37 percent of the exceeding amount to the funding of the equalisation. In 2009, the total amount of grants paid to municipalities and joint authorities of municipalities was 9.4 billion €, whereas the funds in the revenue equalisation system were around 800 million €.

Municipally collected fees and charges account for about a quarter of municipal revenues. Most of the customer charges are collected for services such as water supply, waste disposal, power supply and public transport. Just under one tenth of social welfare and health expenditure is covered through customer and patient charges. Basic education is free.

Municipal cooperation

Many small Finnish municipalities have opted to organise the most demanding tasks through cooperative arrangements. The main form of cooperation is the so called joint authority, but there are also other forms of cooperation such as host municipality arrangements. At best, the variety of cooperation and contracting out solutions have resulted in decentralised, network-based operations models that give the municipalities a flexible way to organise the local public services.

Joint authorities are set up by two or more municipalities mainly for tasks that require a larger population base than the small municipalities can have alone. The most important joint authorities include hospital districts, basic health care (health centres), districts for care of the disabled, vocational education and regional councils. Joint authority is the traditional form of municipal cooperation in Finland. Membership in a joint authority is voluntary with few exceptions, the most important example being hospital services, where each municipality is obliged by law to belong in a hospital district.

Joint authorities are independent legal public entities governed by municipal legislation. They have no taxation rights and their decision makers are chosen by the member municipalities. Joint authorities for social and health care (hospital districts, districts for care of the disabled) are not recipients of State grants. Instead, they are financed by selling their services to municipalities. Joint authorities running hospitals are therefore fully dependent on municipalities buying their services while municipalities pay hospitals according to actual usage at full cost pricing.[6] In 2010 there are 226 joint authorities.

In addition to joint authorities, some municipalities have set up client-producer arrangements, in which one municipality manages some tasks on behalf of the other municipalities. This is called a "host municipality model". The clients are municipal governments and the producers are the host municipalities. Contractual co-operation is common in the areas of waste management, water supply, rescue services, building inspection, consumer and debt counselling, and education. Some contracts are statutory, such as co-operation agreements on rescue services, and contracts for building and maintaining regional emergency dispatch centres.

Public utilities and companies

There are about 150 municipally owned public utilities and 1300 public limited companies whose main owner is a municipality. Limited companies, co-operative societies and foundations offer a possibility to combine public and private capital to implement suitable projects and service systems. For instance, local authorities

[6] The 1993 grant reform had a profound impact on risk sharing of costs in the health care sector. Before the 1993 grant reform, joint authorities first subtracted the grant revenue from the costs and billed municipalities only the average net cost. With matching grants, this actually meant a kind of a risk sharing arrangement in health financing. Today, the municipalities pay the full cost less the non-matching grants that are not influenced by real costs of the municipality.

have established joint waste management companies and urban development and enterprise service companies as well as health care companies.

If a local authority is a major shareholder in a company, or exercises dominant influence in an association or a foundation, they make up together a consolidated corporation. The regulations on municipal corporations determine the policies of the participating companies and communities and their obligation is to report to the local authority. Corporate thinking and steering is more embedded in big urban local governments (Kallio et al. 2005).

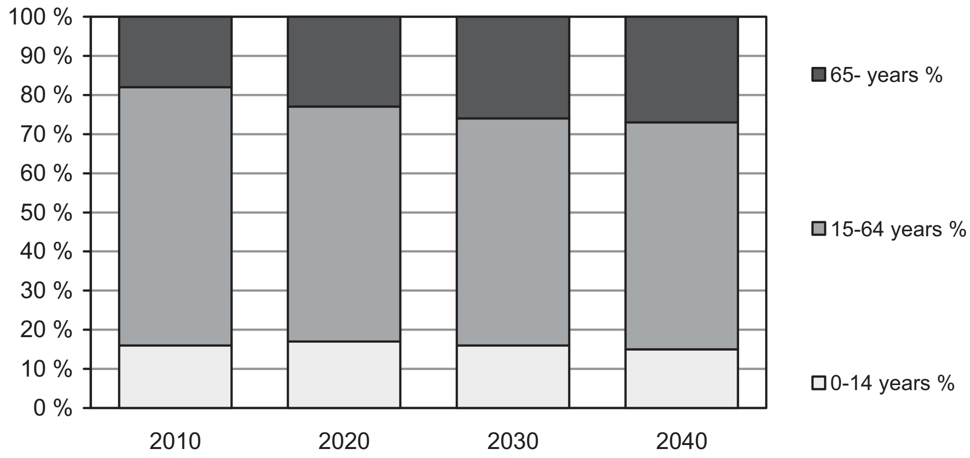
A local authority is also allowed to purchase services from another local authority or the private sector. Competitive tendering for externally purchased services is obligatory according to the Public Procurement Act. According to recent statistics, during 2008 municipalities and joint authorities paid a total amount of 10.8 billion € for outside services, materials and rents, which was 32 per cent of total current expenditure.

4.3 Recent and ongoing local government reforms

The structural reform project (PARAS)

A local government restructuring project was launched in 2005 by central government. The main goal of the project was to create bigger municipalities or enhanced cooperation of municipalities. The project aims to achieve economies of scale and sound capacity in the municipalities to provide services. Bigger municipalities and intensified municipal cooperation are expected to help the municipalities to cope with growing demand for the municipal services due to the aging population (see Figure 4.4 below), that is expected to rapidly increase, especially the demand for health care and elderly care services.

Figure 4.4. Age structure of Finnish population according to population forecast



Source: Statistics Finland

As a follow-up to the restructuring project, the Structural Reform Act was enacted in 2006. According to this Act, municipalities are obliged to prepare plans to reach the predetermined minimum population bases for different activities defined in the Act. In primary health care and associated social services, municipalities should reach a population base of at least 20,000, and in vocational basic education a population base of 50,000. In 2010, only a quarter of health centres had a population base of more than 20,000. Some flexibility is allowed based on archipelago environments, long distances and language and cultural rights. Municipalities have been free to decide whether they reach the minimum population bases with mergers or with enhanced cooperation. In cases where a partnership area is formed, a new joint municipal body must be established for the management of the relevant tasks.

In addition, the biggest urban regions – i.e. the four local authorities in the Helsinki Metropolitan Area as well as 16 other cities in the other parts of Finland with their neighbouring municipalities (altogether 102 municipalities) – had to draw up cooperation plans by 31 August 2007. These plans have to deal with land use, housing and transportation, and use of services across municipal boundaries.

As for municipal mergers, the central government goal was to promote mergers by grants for the mergers during 2008–2013. The grant was 1.8-fold if the merger become effective on January 1st either in 2008 or 2009 and 1.4-fold if the merger is carried out at the start of 2010 or 2011. In connection with the reform, a minor amendment to the basic state grant system was also made in 2009.

In connection with the structural reform, the Ministry of Finance has defined a method to identify municipalities that are in severe economic crisis. The method is based on six economic criteria[7] that aim to measure the fiscal health of the municipalities. If, according to these criteria, the municipal fiscal health is constantly below the country average and during two consecutive years also below the limits specified by the central government, a negotiating procedure is triggered between the municipality and the Ministry of Finance. The aim of the negotiation process is to create an economic rescue plan for the municipality in question. The rescue plan is negotiated separately with each municipality, and it may include measures such as a step-by-step economic recovery plan to be followed in exchange of supplementary aid (discretionary grant) paid by the Ministry of Finance. As an alternative, if the recovery plan cannot be followed, the measures may also include a proposal to make a municipal merger with the neighbouring municipalities. Between 2004 and 2010, altogether 25 municipalities have been involved in the recovery negotiations. There have been more municipalities than these that meet the selection criteria, but the negotiation process has not been started because of voluntary municipal mergers. In addition, from the 25 cases where the negotiating process has been used, five municipalities have merged to another municipality. For the rest of the municipalities, the rescue plan is followed or a merger planning is in process. The negotiating procedure is experimental and will last until 2013, but there are already plans to make this system permanent.

So far, the Structural Reform Act has led to mergers reducing the number of municipalities to 326 (as of January 1st 2010) (see Table 1 below). For the rest of the municipalities, new service provision models based on inter-municipal cooperation have been presented. In health care and welfare services, there will be some 65 cooperative areas by the end of year 2013.

The Ministry of Social Affairs and Health has criticised the implementation of cooperation in health care and social and welfare services based on equity concerns and possible problems in coordination of health and welfare structures. According to the Ministry, the cooperative areas in primary health care do not

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[7] The six criteria used to describe the municipal fiscal health are:

- the annual contribution margin is negative (discretionary grant is not taken into account),
- the income tax rate is at least 0.5 percentage points higher than the weighted national average,
- the per capita amount of long term loans is at least 50 percent higher than the national average,
- the balance sheet shows accumulated deficit,
- the degree of self-sufficiency is below 50 percent,
- the debt-equity ratio is at least 50 percent.

always match the hospital district areas which could cause problems in operating the services. Also, some of the municipalities plan to produce part of the social and welfare services themselves and part through the cooperation which may result in complicated service structures. According to some experts, the cooperation arrangements and gained efficiency in service provision have so far been insufficient, especially regarding the municipal cooperation in the capital region (Stenvall et al., 2009).[8]

Table 4.2. Mergers as outcomes of the PARAS-project

Year	Number of mergers	Total number of municipalities*
2005	10	416
2006	1	415
2007	14	400
2008	1	399
2009	33	332
2010	4	326

* Ecluding the 16 municipalities of the autonomous Åland islands[9]
Source: VATT

As for the effects of municipal mergers, the research evidence seems to be mixed. For example, Moisio and Uusitalo (2003) were unable to find clear evidence of reductions in total per capita expenditure in those Finnish

[8] In addition to the cooperation among the hospital districts of the capital region municipalities, the present capital region cooperative bodies have mainly focused on the Helsinki region's international competitiveness. Regional cooperation focuses particularly on land use, housing and transport issues as well as regional services. Decisions on the details of the cooperation are made under an annual action plan. At present, there are two main bodies of capital city area cooperation. First, the Helsinki Metropolitan Area Advisory Board consists of leading elected officials in the cities of Helsinki, Vantaa, Espoo and Kauniainen. The activities of the Advisory Board are based on decisions made by the city councils of the cities involved. Items on the agenda are prepared at mayors' meetings, and a joint work plan is adopted every year. Another cooperative body for the whole Helsinki region is the Helsinki Region Cooperation Assembly that came into force on 1 October 2005. The Assembly consists of the leading elected officials of the fourteen municipalities in the Helsinki region.

[9] The autonomy of the Åland Islands is established on the basis of the autonomy granted to it by international treaties. In the framework of its autonomy, the Åland Islands has its own political and administrative organs responsible for decision-making. The Parliament of Åland exercises legislative power within the framework permitted by its autonomous position. Otherwise the laws enacted by Finland's Parliament apply. The Government of Åland is responsible for regional administration (source: State Treasury).

municipalities that had already merged. In addition, Loikkanen and Susiluoto (2005) studied municipalities (with populations above 2,000) as multiple service providers and found that the most cost efficient municipalities were relatively small. When population was included in regression models explaining cost efficiency, it got a negative sign. Alternative models indicated that municipalities with a population below 10,000 seemed to be less efficient than those in the range from 10,000 to about 40,000 inhabitants. In this range population did not explain efficiency differences practically at all. Finally, the biggest cities had relatively low cost efficiency in the provision of basic welfare services. On the other hand some other studies that have concentrated on specific municipal services suggest that the optimal size of the municipality for that service is somewhere between 20,000 and 40,000. Hence, if such services are chosen to determine municipality size there seem to be grounds for increasing the average size of the municipalities from the present 15,000 (Aaltonen et al 2006, Aaltonen et al 2009). However, the fact that the government policy is based on voluntary mergers with an obligatory 5 year period of transition may make it difficult to reach productivity improvements with municipal mergers. This is because during the transition period, no structural changes can be made without consensus agreements. It also seems that the municipalities who decide to merge are those who have had a history of joint cooperation (Saarimaa and Tukiainen, 2010). Hence, it is possible that the economies of scale have been utilised already prior to the merger. Furthermore, it is not clear that the municipalities that end up merging, would necessarily be the best combinations to achieve cost savings.

The administrative experiment of Kainuu region

An administrative experiment that created a regional level authority for cooperation and decision-making was launched in the Kainuu region[10] in 2005. The experiment will last until 2012. The general aim of the experiment is to strengthen the municipal economic base in Kainuu area by operating on a larger scale and to enable equality of access to services throughout the region.

The Kainuu regional level authority is in charge of planning, health care, social services (except daycare) and secondary schooling. In addition, the regional authority provides the main financial administration and IT services. Altogether, some 60 percent of local government tasks are provided at the regional level in the Kainuu area.

Kainuu regional authority is governed by a council that is elected every fourth year by people entitled to vote in the region in direct local elections. The

[10] Kainuu region is located in remote North-Eastern Finland and comprises nine municipalities. The area is among the poorest in Finland.

financing of the Kainuu regional authority comes from the nine member municipalities. Each municipality in Kainuu region pays 60.1 percent of their agreed revenue (including tax revenues and grants) to the regional authority.

The regional authority in Kainuu differs from the traditional joint authorities mainly with its elected council and the wide extent of cooperation. Another important difference is that the Kainuu regional authority gets a fixed sum from municipalities to finance its budget, whereas the other joint authorities in Finland are mostly financed by municipal member fees that are based on actual service usage and full cost pricing of the services. A Ministry of Finance (2010a) working group has recently considered different alternatives to finance Kainuu regional authority and proposed that the present financing system should be maintained, if the experiment will be continued. Hence, there are currently no plans to reshape the Kainuu regional authority to an intermediate level government unit in the same vein as for example the county level governments in Sweden with own taxation rights.

According to a recent follow-up report, the Kainuu experiment has been able to cut the costs of service provision. In addition, the report claims that the municipal decision-making in Kainuu has been eased because of the experiment (Jäntti et al. 2010). Also the recent OECD Public Governance Review for Finland (OECD 2010) discusses the Kainuu experiment. According to the OECD study, the Kainuu experiment has shown some positive results, especially by creating economies of scale and scope and by promoting new ways for service delivery. But as the experiment is still ongoing and because there are no sector specific efficiency studies of the Kainuu experiment, it is yet too early to draw definite conclusions about the effects of the experiment. A potential problem with the Kainuu experiment is the accountability – exactly the same challenge that concerns the other joint authorities – because voters and taxpayers do not have the same decision-making power at municipal and regional level in Kainuu.

Therefore, one way to deepen the Kainuu administrative experiment after 2012 could be to establish a true regional local self-government unit with elected council and own taxation rights. But as the Ministry of Finance (2010a) report has shown, there are some major legal and administrative obstacles on the way, because municipal self government and taxation rights are secured in the Constitution.[11] The second alternative could be that the experiment would end in 2012 to a municipal merger of the nine municipalities. In any case, at this point it is probably not possible to dissolve the experiment completely because the

[11] In addition, there have also been fears that the right to tax at regional level would increase the tax burden when municipal tax is added on the top of municipal income tax. This could perhaps resisted with (temporary) limit on total local government tax.

experiment has shown some positive results and because it would be very costly to go back to the original situation with nine separate municipalities. This latter point concerns especially the healthcare services. In sum, the Kainuu administrative experiment has shown that regional authority can be a serious alternative to municipal mergers, at least in the most remote and poorest areas of Finland.

Proposals to reform the health care

The Ministry of Health and Welfare is at the moment preparing proposals to renew the system of public health care services so that the patients would have more rights to choose service producers across municipal borders. The aim is that local governments should establish functionally larger health care districts that take care of both special and primary health care services. At the moment it is unclear whether these plans will result in actual reforms.

Plans to reform the metropolitan area administration in the capital city area

The City of Helsinki, the capital city of Finland, and its neighbouring municipality, the City of Vantaa, are investigating jointly the viability of a municipal merger. In addition, the feasibility of a new intermediate level of government in the Helsinki region is under study. These studies will outline the pros and cons of the proposed merger and the intermediate government level in the capital city area. The study's final report will aim to help the council members of the two cities to decide whether the formation of one large city would bring more benefits than drawbacks. The merger could be a reality by 2011 if council members agree to pursue the merger. The third big city in the area, City of Espoo, has not agreed to take part in these investigations. The merger of Helsinki and Vantaa would bring the capital's population to over three quarters of a million.

4.4 Finnish local government compared internationally

The purpose of this section is to perform a selective international comparison of structures of local government, their tasks (outlay structures) and main sources of revenue. Here, after describing government structures, we mainly confine ourselves to unitary countries within the group of EU15. This makes it possible to present the case of Finland relative to other rather similar countries.

The information in this section is based on IMF Government finance statistics (outlays and revenues). Description of government structures is based on CEMR (Council of European Municipalities and Regions) information. A fundamental difficulty is that most of it concerns all sub-national tiers of government, not only municipalities and even in most unitary countries (except Finland), there is more than one tier below central government.

The structure of government differs across countries in many respects. First, some countries are federations and have states or the like as the next tier under central government. Federal countries tend to be big in population, but in Europe they also include Austria and also since 1993, Belgium. Then there are unitary countries, which have either only one or several lower tiers of government. By tier, we mean here levels with their own democratic decision making units, tasks and with taxing powers. Table 4.3 summarizes the tiers of sub-national government in a number of European countries in 2005, and separately for unitary and federal countries. The number of government units at each tier is also given.

The number of municipalities varies dramatically from one country to another. Of the big unitary countries, France, Italy and Spain have a lot of them whereas the UK has very few. Among the included Nordic countries Finland was in 2005 the only one with a two tier system where only the municipalities represent sub-national government. Here, Finnish municipal joint authorities are not counted as a separate level. Also, nineteen regions (maakunta) are not listed as an intermediate tier. Their tasks include regional land use planning, which in principle is of great importance for the settlement structures and indirectly also for public service networks. In practice, the regional councils have had little power relative to municipalities, which have according to law land use (zoning) monopoly in their area. They also represent regions under the direction of central government and deal with EU projects. Thus, regional councils represent in practice just a form of municipal cooperation (joint municipal authority). The regional council members are not directly elected citizens, but are nominated by the member municipalities. In addition to limited tasks, the critical reason for not regarding regions and their councils as a tier of government is that they lack own revenue sources. Finnish regional governments have no powers of taxation. Unlike the Finnish case, Sweden and Norway have intermediate tiers (counties) with elected councils with their own tasks and revenue sources. This situation demonstrates that the degree of decentralisation to municipalities in Finland is extensive. They provide (and mostly produce) many health care, education and infrastructure services which are tasks of intermediate or even higher levels of government in the other Nordic countries.

Table 4.3. Sub-national government structure in some unitary European countries in 2005

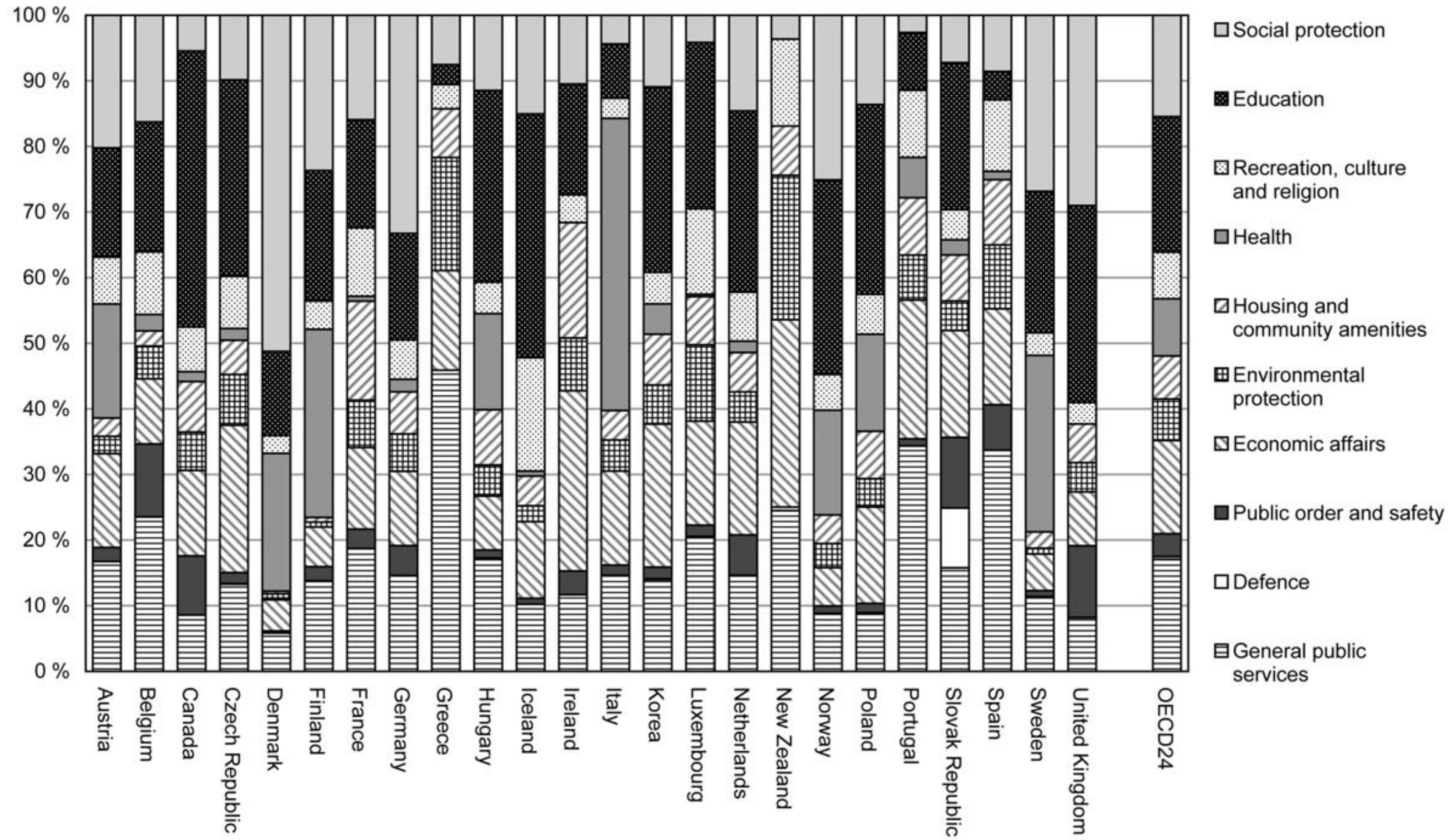
Country	Regional or state governments	Intermediate regional government	Local government
Unitary countries			
Denmark		5 counties	98 kommuner
Finland			416 kuntaa
France	26 regions	100 departements	36.683 communes
Ireland		29 counties	85 munipalicities
Italy	20 regions	103 provinces	8.102 comuni
Greece		50 prefectures	1.034 munipalicities
Luxemburg			116 communes
Netherlands		12 provinces	443 gemeenten
Norway		19 fylkeskommuner	430 kommuner
Portugal	2 auton.regions		308 municipalities
Spain	17 regions	50 provinces	8.111 municipalities
Sweden		20 counties	290 kommuner
UK	3 regions	35 counties	437 districts

[1] The governments included should have both elected bodies and own revenue sources.

Main source: CEMR

The tasks and related expenditure structures of sub-national government (Figure 4.5) reveal some noteworthy differences among unitary countries. In the UK and Ireland, for instance health is not a task at sub-national level, and its role is small in France and the Netherlands also. In Finland and Denmark the opposite is true. In Denmark, unlike elsewhere, outlays at sub-national level include presumably items included in social protection (related to pensions) which are absent in other countries. This explains partly why the sub-national sector (Figure 4.5) is also big in Denmark.

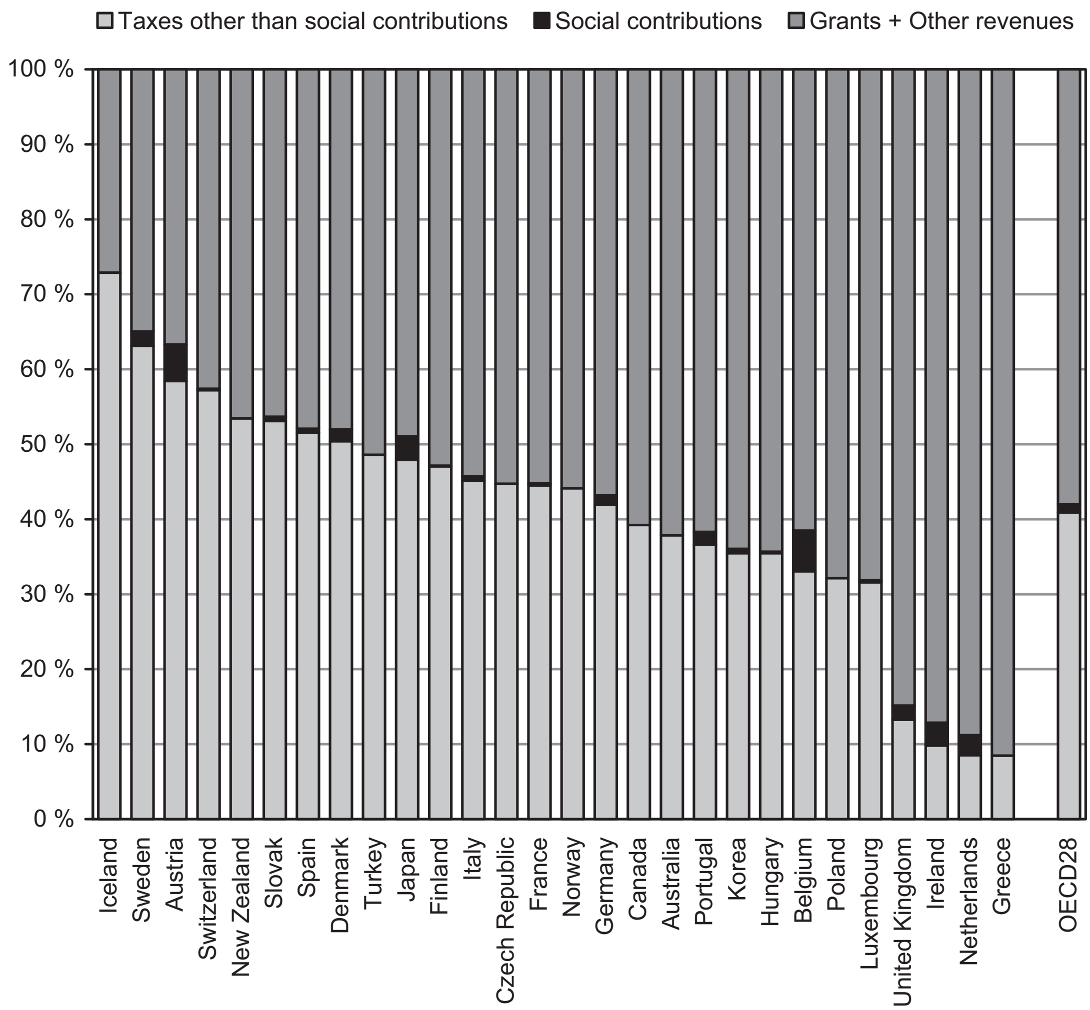
Figure 4.5. Structure of local government expenditures by function in 2006



Data extracted in October 2008, except New Zealand, Norway and United Kingdom in 2005.
Source: OECD

To get an idea of the basic structure of local finance, the revenue side of local government is divided into tax revenue, non-tax revenue and grants (Figure 4.6). There is quite a lot of variability in the revenue structures. The share of taxes at local level range roughly from 10 to 70 per cent. The range for grants is from 10 to 70 per cent, and the typically smaller share on non-tax revenue ranges from less than 10 per cent to about 35 per cent.

Figure 4.6. Structure of local government revenues in 2006



Source: OECD

The above international comparison indicates that Finland is an exceptionally decentralised country. Several tasks, which are handled elsewhere at higher levels of government (or tiers) than municipalities, are taken care of by the local governments and their joint organisations. Besides local infrastructure and local public goods, the merit goods of education, health and social services, are also provided by Finnish municipalities. The latter tasks have been devolved to municipality level by decisions of the National Parliament, but their finance is shared. In addition to block grants, municipalities levy income taxes on individuals' incomes and receive shares of corporate tax revenues. Property taxation, introduced in 1993 has had a minor role.

Many of the countries considered deviate from Musgrave's (1959) principles of fiscal federalism in some respects. Finland is a rather extreme case even among them in solving the assignment problem of tasks and revenue sources to the lowest tier (municipalities). As for tasks, local public goods have a minor role compared to merit goods which are redistributive. As a result of this, Finnish municipality reforms concentrate predominantly on solving problems of health care and desired municipality size, something that has no role or only a minor role elsewhere at local level. The revenue structure also deviates from Musgravian principles which for instance UN-Habitat (2009) advocates to be applied globally. The small role of property taxation in Finland is one example of this. Reliance on corporate income (profits) taxation is another example, which is counter to the principle of centralised stabilization. According to this principle, revenue sources at local level should be more stable than at central level. As for the important role of local income tax, this is necessary given the large amount of tasks and the principle that municipalities cover part of the related costs from their own revenue sources.

4.5 Discussion

Finnish local public sector appears to be a unique case in the country comparisons. This is not just because of the country's large public sector or the high degree of decentralisation. The fact that in Finland there is a single tier of local government – the municipalities – is also only a part of the explanation.

The thing that especially characterises Finnish local government is the extensive and sometimes complicated structure of cooperation between the municipalities. In order to cope with scarce resources, wide responsibilities, small population size and challenging operating environment, cooperation between municipalities has been essential. As a result, the smallest municipalities have been involved in a number of separate voluntary and partly obligatory cooperative coalitions. Some small municipalities have even been described as being purchasing organisations rather than municipalities in a traditional sense. This is just a minor exaggeration.

In Finland, the joint municipal authorities and other inter-municipal cooperation have effectively replaced the "missing" government tier at the local level. As such they correspond to special purpose entities which are used for certain purposes (like schools, waste management etc) in many countries, but in Finland they do not have directly elected decision making bodies and an own finance system. In fact this solution, together with central government aid, has ensured that the smallest municipalities in Finland have been able to operate at all.

Judged by the country comparisons performed by OECD and others, it seems that Finnish local public sector is performing fairly well. This is the case at least when comparing the outcomes and per capita expenditures. With this information, one may ask: why should we be worried about the future of Finnish local government?

But the truly big question in Finland at the moment is: even if the system has worked in the past, will it work in the future, too? Indeed, the future for the Finnish local government does not look very bright. With a rapidly aging population, growing numbers of retiring municipal employees, and diminishing tax bases, it may be very difficult to carry on with the old ways.

Having anticipated this, the government has taken steps to tackle the situation. With increased financial incentives for voluntary municipal mergers, regulations to enhance cooperation, requirements for productivity programme regarding the 20 biggest municipalities and the initiatives to improve the cooperation of the main Metropolitan areas, the government hopes to be able to strengthen local government. But it will take years before the effects of these policy actions become evident.

In addition to the measures already decided, there have been proposals for further policy measures. These include transferring the health care provision from the municipal sector to "health care districts" or even centralising the health care provision to be administered using a single "health care fund". These proposals however have not yet been very detailed in practice, i.e. how to organise the decision-making bodies in these institutions, and how to ensure that the local needs and circumstances will be taken into consideration. As for the policy concerning the municipal structure, some have argued for compulsory mergers to speed up the structural change.

Over the years, there has been some discussion about new intermediate levels of government with its own tax base and elected councils, but so far these proposals have not gained much political support. At the moment, the Kainuu region experiment is the only example of an intermediate level solution in Finland. The proponents of intermediate level government in Finland have argued that the regional level of government allows better coordination and helps to address the externalities associated, for example, with land use planning and transportation. These tasks are conventionally regarded as key ones for local and regional governments, since land use patterns (densities) affect the productivity of the private sector (World Bank 2009) and also the networks for public service provision. The nature of these networks consisting of several service units can have more impact on efficiency than the mere size of municipalities.

Currently, the control of land use, housing and transportation are not tasks performed by regional councils in Finland. Regional councils mainly make plans and cannot decide on important matters such as land use. Namely, municipalities have legal zoning monopoly in their area and do not need to accept plans proposed by regional councils. According to some experts, there is thus a genuine need to have a regional body with more power in these issues. They argue that one reason for the scattered population structure and low density and sprawled urban fabric in Finland is the lack of binding land use plans that cover the whole region and not just single municipalities. The present situation permits an owner of a property to build almost anywhere as municipalities with zoning monopoly, usually allow such developments to take place. A new intermediate level with its own tasks related to land use, transportation etc. and its own revenue sources is an alternative, but then regional councils in the current form are hardly needed. There is also a democracy point of view to this, as an intermediate level of government with elected councils could enhance local democracy and add transparency to decision-making. Intermediate government level could also be a stronger player in negotiations with central government.

The critics of an intermediate government tier argue, instead, that introducing a new intermediate level of government could result in waste of resources and duplication in the provision of the services. In a situation where the public sector should improve productivity and reduce administrative expenditures, the intermediate level of government does not seem like a good idea if it leads to increased expenditures. It has also been argued that as Finnish municipalities are already utilising the economies of scale with intensive cooperation, and as the grant system addresses much of the spillover effects, there do not seem to be many economic arguments left for the new intermediate levels of government. It has also been pointed out that the experiences of the intermediate levels of government from the other Nordic countries do not seem very promising from the efficiency side. Norway has recently transferred the hospitals from the intermediate level to central government and Denmark has reduced the number of intermediate governments and their tasks.

The present system of voluntary cooperation between municipalities is defended with the argument that it retains the local autonomy and accountability. A locally decided combination of own production, joint provision and contracting out may give the municipalities the possibility to address economies of scale or service spillovers on a service by service basis. This can help the municipalities to find the most flexible way to organise their services, which may be good for cost efficiency. According to this opinion, the present model needs only slight modification, for example by amalgamating some of the weakest municipalities to create stronger independent municipalities. With more equal partners for cooperation, the inter-municipal cooperation could concentrate on services that truly need larger scale of operation.

As single tier of local government seems to be strongly rooted in the Finnish thinking, no radical change on this seems likely. Hence, the present government policy which is based on gradual increase of average municipal size and enhanced cooperation is likely to continue. Having said this, it is still possible that in special cases such as the capital city area, new administrative models will be considered.

But even if no ground-breaking change would be seen in the municipal administration, a small revolution may lie ahead in the utilisation of market mechanisms. While the separation of provider and producer roles in the municipalities has been the traditional attempt to utilise market mechanisms, some municipalities have recently outsourced part or all of their health care to private health care companies. In addition, new proposals to increase the freedom of consumer choice have been advanced. A new law of vouchers was enacted in 2009 with the aim to enhance the use of vouchers in social and health care services. So far, vouchers have been used on a small scale in services like nurse visits to home or other home care help. But at the moment the applications of voucher systems are rapidly increasing in many municipalities. It seems that so far the experiences of vouchers have been positive. Also, recent research results show that optimally designed vouchers can generate savings in Finnish health care, although vouchers are not suitable for all services and all cases.

Finnish local government is in a stage of transition. At the moment it is not clear whether the already decided reforms on local government will be sufficient. It seems that the question of balance between municipal tasks and financing is still unsolved. In order to be able to do this, the central government policy towards local government sector needs to be better coordinated. The burden of tasks of the municipalities should no longer be increased. During the past decades, the central government ministries have delegated various tasks to municipalities. Perhaps now the political discussion about which tasks should be provided locally and which tasks should be centralised or privatised, should start again.

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Chapter 5

Adapting to a Changing World: Reflections on the Reform of Local Governance for the Next Decade

Anwar Shah

5.1 Introduction

In recent decades, globalization and the information revolution have brought about profound changes in the governance structures within and across nations. Globalization has lifted millions of people out of poverty, and the information revolution has brought about a degree of citizen empowerment and activism in state affairs that is unparalleled in past history. They have also acted as catalysts for "reshuffling" government functions within and beyond nation states. Globalization also meant liberating markets and bringing market discipline to governments. Recent global financial crisis has significantly shattered common faith in workings of the free markets. Providing bailouts to markets have also endangered the fiscal health of government around the globe while creating a crisis in public confidence in national politics and leadership. This chapter reflects upon special challenges in adapting multi-order governance to make them incentive compatible with growth with equity and fiscal sustainability, urgency of which is brought home by these mega changes.

The chapter is organized as follows. Section 5.2 discusses roles and responsibilities of local governments for the new economic order and examines the relevance of current practices to the emerging new paradigm in local governance. Section 5.3 is concerned with structure and organization of local governments. Section 5.4 is concerned with financing regime for local governance and grant financing options for local governments are discussed in section 5.5. Section 5.6 is concerned with budgetary institutions for local fiscal discipline. Section 5.7 provides a framework for measuring and monitoring government performance. A final section provides some conclusions.

5.2 The Role of Local Governments in Multi-order Governance

Motivations for rethinking the role of local governments

Globalization and information revolution has brought about a paradigm shift in international competitiveness of nations. Economic prosperity of a nation is now more closely linked to the knowledge, skills and information base of its citizens rather than the country's resource endowments. It is increasingly recognized now that local governments, especially cities, are at the core of the future prosperity of a nation in view of their better positioning to forge a competitive advantage to spur economic growth by fostering a new knowledge based economy. With capital mobility and deregulation, local governments as providers of infrastructure related services, are more appropriate channels for attracting domestic and foreign investment. Cities are increasingly becoming important players in international economic alliances. Global financial crisis has diminished people's trust both in the markets and role of central governments in regulating such markets. With a cloud of fiscal distress looming over the world horizon from bailouts of financial markets, local governments may also hold the key to fiscal heath and sustainable public finances as costly centrally determined and delivered services are replaced by locally demanded and competitively delivered services at the local level. Closer to home, people are increasingly more likely to link their identities with local jurisdictions and are demanding higher quality local services to improve economic and social outcomes. But local governments with few exceptions (e.g. China, Denmark and Finland) are hamstrung to play a leadership role in local economic development in view of the constraints imposed by higher orders of government. To reshape the role of local governments to conform to the new world economic order, one has to review both the theory and the past legacy in practice.

Roles and Responsibilities of Local Governments: Analytical Underpinnings

There are five perspectives on models of government and the roles and responsibilities of local government: (a) traditional fiscal federalism, (b) new public management (NPM), (c) public choice, (d) new institutional economics (NIE), and (e) network forms of local governance. The federalism and the NPM perspectives are concerned primarily with market failures and how to deliver public goods efficiently and equitably. The public choice and NIE perspectives are concerned with government failures. The network forms of governance perspective is concerned with institutional arrangements to overcome both market and government failures.

Local government as a handmaiden of a higher government order: Traditional fiscal federalism perspectives.

The fiscal federalism approach is focused on internalizing benefits and costs of service provision to the same jurisdiction and treats local government as a subordinate tier in a multi-tiered system and outlines principles for defining the roles and responsibilities of various orders of government (see Boadway and Shah 2009 for such a framework for the design of fiscal constitutions). Hence, one sees that in most federations, as in Canada and the United States, local governments are creatures of state (intermediate order) governments (*dual federalism*). In a few isolated instances, as in Brazil, they are equal partners with higher-level governments (*cooperative federalism*), and in an exceptional case, Switzerland, they are the main source of sovereignty and have greater constitutional significance than the federal government. Thus, depending on the constitutional and legal status of local governments, intermediate order governments in federal countries assume varying degrees of oversight of the provision of local public services. In general, this perspective constrains the role of local governments as their expansive role comes at the expense of the powers of the intermediate order of government. As globalization and information revolution leads to diminished economic relevance of the intermediate order of governments, these conflicts are accentuated and intermediate order governments have a tendency to play a more intrusive role at the local level to stay politically relevant. The fiscal federalism perspectives serve as a response to market failures and heterogeneous preferences with little recognition of government failures or the role of entities beyond government.

Local government as an independent facilitator of creating public value: New public management perspectives.

Two interrelated criteria have emerged from the NPM literature in recent years determining, first, what local governments should do and, second, how they should do it better. It argues that the role of public managers in local governments is to tap free resources of the community (goodwill, good Samaritan values) and push the frontiers of improved social outcomes beyond what may be possible with meager local revenues (Moore, 1996). Thus, public managers create value by mobilizing and facilitating a network of providers beyond local government. This environment, focused on creating public value, encourages innovation and experimentation, bounded by the risk tolerance of the median voter in each community. The main current of the NPM literature is concerned not with what to do but with how to do it better. It argues for an incentive environment in which managers are given flexibility in the use of resources but held accountable for results. Top-down controls are thus replaced by a bottom-up focus on results.

Local government as an institution to advance self-interest: The public choice approach.

The public choice literature endorses the self-interest doctrine of government and argues that various stakeholders involved in policy formulation and implementation are expected to use opportunities and resources to advance their self-interest. This view has important implications for the design of local government institutions. For local governments to serve the interests of people, they must have complete local autonomy in taxing and spending constrained only by direct democracy provisions and they must be subject to competition within and beyond government. In the absence of these prerequisites, local governments will be inefficient and unresponsive to citizen preferences (Boyne 1998, Bailey 1999).

The government as a runaway train: Neo-institutional economics (NIE) concerns with the institutions of public governance.

The NIE provides a framework for analyzing fiscal systems and local empowerment and for comparing mechanisms for local governance. This framework is helpful in designing multiple orders of government and in clarifying local government responsibilities in a broader framework of local governance (see Shah and Shah, 2006). According to the NIE framework, various orders of governments (as agents) are created to serve the interests of the citizens as principals. The jurisdictional design should ensure that these agents serve the public interest while minimizing transaction costs for the principals.

The existing institutional framework does not permit such optimization, because the principals have bounded rationality; that is, they make the best choices on the basis of the information at hand but are ill informed about government operations. Enlarging the sphere of their knowledge entails high transaction costs, which citizens are not willing to incur. Those costs include participation and monitoring costs, legislative costs, executive decision-making costs, agency costs or costs incurred to induce compliance by agents with the compact, and uncertainty costs associated with unstable political regimes (Horn 1997; Shah 2007). Agents (officials of various orders of governments) are better informed about government operations than principals are, but they have an incentive to withhold information and to indulge in opportunistic behaviors or “self-interest seeking with guile” (Williamson 1985, 7). Thus, the principals have only incomplete contracts with their agents. Such an environment fosters commitment problems because the agents may not follow the compact. The situation is further complicated by three factors – weak or extant countervailing institutions, path dependency, and the interdependency of various actions. Countervailing institutions such as the judiciary, police, parliament, and citizen activist groups are usually weak and unable to restrain rent-seeking by politicians and bureaucrats. Historical and cultural factors and mental models by which people see little benefits to and high costs of activism prevent corrective action. Further, empowering local councils to take action on behalf of citizens often leads to loss of agency between voters and councils, because council members may interfere in executive decision making or may get co-opted in such operations while shirking their legislative responsibilities. The NIE framework stresses the need to use various elements of transaction costs in designing jurisdictions for various services and in evaluating choices between competing governance mechanisms.

Local government as a facilitator of network forms of local governance.

Given the high transaction costs and perceived infeasibility of market and hierarchical mechanisms of governance for partnerships of multiple organizations, a network mechanism of governance has been advanced as a possible mode of governance for such partnerships – the kind to be managed by local governments. The network form of governance relies on trust, loyalty, and reciprocity between partners with no formal institutional safeguards. Networks formed on the basis of shared interests (interest-based networks) can provide a stable form of governance if membership is limited to partners that can make significant resource contributions and if there is a balance of powers among members. Members of such networks interact frequently and see cooperation in one area as contingent on cooperation in other areas. Repeated interaction among members builds trust. Hope-based networks are built on the shared sentiments and emotions of members. Members have shared beliefs in the worth and philosophy of the network goals and have the passion and commitment to achieve those goals. The stability of such networks is highly dependent on the commitment and style of their leadership (Dollery and Wallis 2001) and the catalytic and mediating role played by local governments.

A synthesis: Reshaping the Role of Local Governments for the 21st Century

We have reviewed ideas emerging from the literature on political science, economics, public administration, law, federalism, and the NIE with a view to developing an integrated analytical framework for the comparative analysis of local government and local governance institutions. The dominant concern in this literature is that the incentives and accountability framework faced by various orders of government is not conducive to a focus on service delivery consistent with citizen preferences. As a result, corruption, waste, and inefficiencies permeate public governance. Top-down hierarchical controls are ineffective; there is little accountability because citizens are not empowered to hold governments accountable.

Multi-order governance practices around the world are focused on structures and processes, with little regard for outputs and outcomes. These practices support top-down structures with preeminent federal legislation (that is, federal legislation overrides any sub-national legislation). The central government is at the apex, exercising direct control and micromanaging the system. Hierarchical controls exercised by various layers of government have an internal rule-based focus with little concern for their mandates. Government competencies are determined on the basis of technical and administrative capacity, with almost no regard for client orientation, bottom-up accountability, and lowering of transaction costs for citizens. Various orders of government indulge in uncooperative zero-sum games for control. This tug of war leads to large swings in the balance of powers. Shared rule is a source of much confusion and conflict, especially in federal systems. Local governments are typically creatures of states or provinces and given straitjacket mandates. They are given only limited home rule in their competencies. In short, local governments in this system of "federalism for the governments, by the governments, and of the governments" get crushed under a regime of intrusive controls by higher levels of governments. Citizens also have limited voice and exit options.

The governance implications of such a system are quite obvious. Various orders of government suffer from agency problems associated with incomplete contracts and undefined property rights, as the assignment of taxing, spending, and regulatory powers remains to be clarified – especially in areas of shared rule. Intergovernmental bargaining leads to high transaction costs for citizens. Universalism and pork-barrel politics result in a tragedy of commons, as various orders of government compete to claim a higher share of common pool resources. Under this system of governance, citizens are treated as agents rather than as principals.

On how to reverse this trend and make governments responsive and accountable to citizens, the dominant themes emphasized in the literature are the subsidiarity principle, the principle of fiscal equivalency, the creation of public value, results-based accountability, and the minimization of transaction costs for citizens, as discussed earlier. These themes are useful but should be integrated into a broader framework of citizen-centered governance, to create an incentive environment in the public sector that is compatible with a public sector focus on service delivery and bottom-up accountability and also incentive- compatible with globalization. Such integration is expected to deal with the commitment problem in various levels of government by empowering citizens and by limiting their agents' ability to indulge in opportunistic behavior. Table 5.1 provides general principles for rethinking the role of local government based upon a synthesis of the conceptual and empirical literature.

Table 5.1. The Role of a Local Government under the New Vision of Local Governance

Old view: 20th century	*New view: 21st century*
Is based on residuality and local governments as wards of the state	Is based on subsidiarity and home rule
Is based on principle of ultra vires	Is based on community governance
Is focused on government	Is focused on citizen-centered local governance
Is agent of the central government	Is the primary agent for the citizens and leader and gatekeeper for shared rule
Is responsive and accountable to higher-level governments	Is responsive and accountable to local voters; assumes leadership role in improving local governance
Is direct provider of local services	Is purchaser of local services
Is focused on in-house provision	Is facilitator of network mechanisms of local governance, coordinator of government providers and entities beyond government, mediator of conflicts, and developer of social capital
Is focused on secrecy	Is focused on letting the sunshine in; practices transparent governance
Has input controls	Recognizes that results matter
Is internally dependent	Is externally focused and competitive; is ardent practitioner of alternative service delivery framework
Is closed and slow	Is open, quick, and flexible
Has intolerance for risk	Is innovative; is risk taker within limits
Depends on central directives	Is autonomous in taxing, spending, regulatory, and administrative decisions
Is rules driven	Has managerial flexibility and accountability for results
Is bureaucratic and technocratic	Is participatory; works to strengthen citizen voice and exit options through direct democracy provisions, citizens' charters, and performance budgeting
Is coercive	Is focused on earning trust, creating space for civic dialogue, serving the citizens, and improving social outcomes
Is fiscally irresponsible	Is fiscally prudent; works better and costs less
Is exclusive with elite capture	Is inclusive and participatory
Overcomes market failures	Overcomes market and government failures
Is boxed in a centralized system	Is connected in a globalized and localized world

Source: Shah and Shah (2006, 2007)

The framework emphasizes reforms that strengthen the role of citizens as the principals and create incentives for government agents to comply with their mandates. The commitment problem may be mitigated by creating citizen-centered local governance – by having direct democracy provisions, introducing governing for results in government operations, and reforming the structure of governance, thus shifting decision making closer to the people. Direct democracy provisions require referenda on major issues and large projects and require that citizens have the right to veto any legislation or government program. A "governing for results" framework requires government accountability to citizens for service delivery performance. Hence, citizens have a charter defining their basic rights as well as their rights of access to specific standards of public services. Output-based intergovernmental transfers (discussed in section 5.4) strengthen compliance with such standards and strengthen accountability and citizen empowerment.

Implications for division of powers within nations: Role reversals for central and local governments

The framework described above has important implications for reforming the structure of government. Top-down mandates on local governance will need to be replaced by bottom-up compacts. Furthermore, the role of local government must be expanded to serve as a catalyst for the formulation, development, and operation of a network of both government providers and entities beyond government. Local government's traditionally acknowledged technical capacity becomes less relevant in this framework. More important are its institutional strengths as a purchaser of services and as a facilitator of alliances, partnerships, associations, clubs, and networks for developing social capital and improving social outcomes. Two distinct options are possible in this regard, and both imply a pivotal role for local governments in the intergovernmental system. The options are (a) local government as the primary agent, subcontracting to local providers, regional (state), and federal or central government authorities and engaging networks and entities beyond government, and (b) local, regional (state), and national governments as independent agents.

Option A: Local governments as primary agents of citizens. In this role, a local government serves as (a) a purchaser of local services, (b) a facilitator of networks of government providers and entities beyond government, and (c) a gatekeeper and overseer of state (intermediate order) and national governments for the shared rule or responsibilities delegated to them. This role represents a fundamental shift in the division of powers from higher to local governments. It has important constitutional implications. Residual functions reside with local governments. Regional governments would not be directly elected and would simply be constituted from local government representatives to perform inter-municipal services as is presently the case in Finland. The national government is assigned redistributive, security, foreign relations, and interstate (inter-regional) functions such as harmonization and consensus on a common framework. The Swiss system bears some affinity to this model and Finland incorporates elements of this framework.

Option B: Various orders of government as independent agents. An alternative framework for establishing the supremacy of the principals is to clarify the responsibilities and functions of various orders as independent agents. This framework limits shared rule. Finance follows function strictly, and fiscal arrangements are periodically reviewed for fine-tuning. Local governments enjoy home rule, with complete tax and expenditure autonomy. The Brazilian fiscal constitution incorporates some features of this model, albeit with significant deviations.

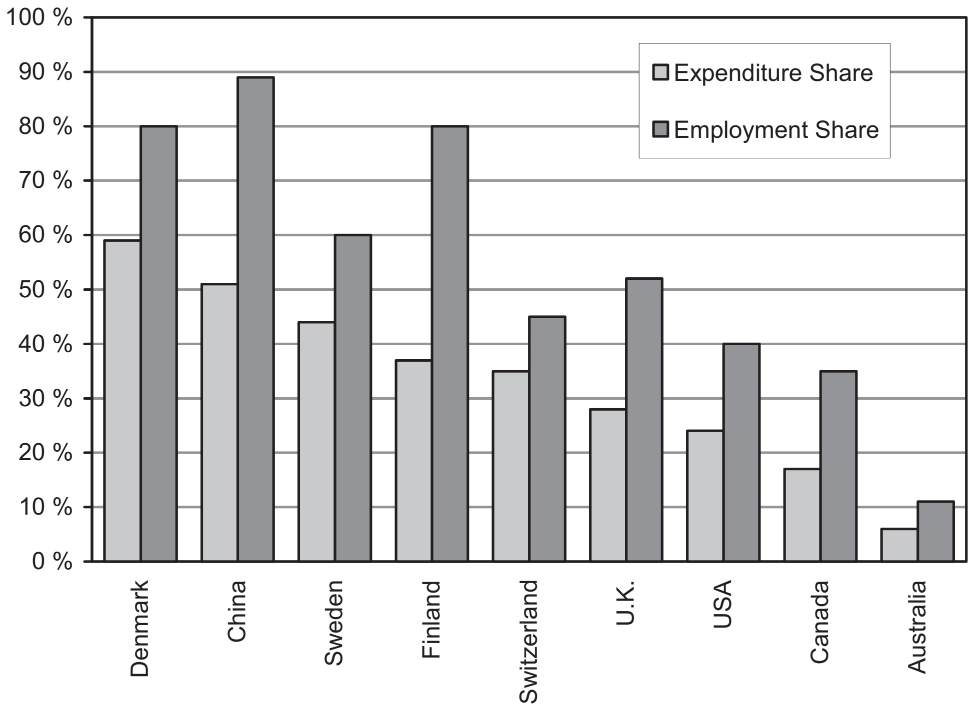
Feasibility of options. Option A is well grounded in the history of modern governments and is most suited for countries with no history of internal or external conflict in recent times. It is already practiced to some degree in Switzerland, Finland, Denmark and Sweden. War, conquest, and security concerns have led to a reversal of the roles of various orders of governments and to a reduction in local government functions in more recent history. Globalization and the information revolution have already brought pressures for much larger and stronger roles for local governments. Although a majority of governments have done some tinkering with their fiscal systems, the radical change recommended here is not in the cards anywhere. This is because the unlikelihood of overcoming path dependency – a tall order for existing institutions and vested interests – makes such reform infeasible. Under such circumstances, option B may be more workable, but here the clarity of responsibilities may not be politically feasible. In general, there is unlikely to be political will to undertake such bold reforms. Piecemeal adaptation of this model will nevertheless be forced on most countries by the effects of globalization and by citizen empowerment, facilitated by the information revolution.

The Practice of Local Governance and Lessons for Reform

The legal status of local government varies across industrial countries, with local government deriving authority from national constitutions in Denmark, France, Germany, the Netherlands, and Sweden; from state constitutions in Australia, Switzerland, and the United States; and from national legislation in the United Kingdom and New Zealand and from provincial legislation in Canada. It is interesting that there is no clear pattern in the autonomy and range of local services provided by local governments deriving their status from national and state constitutions. However, local governments that are created through legislation are significantly weaker.

The relative importance of local governments in industrial countries is compared using two indicators: share of consolidated public sector expenditures and local expenditures as a percentage of GDP. On both indicators, Nordic countries are the leaders; the United Kingdom and United States are in the lower ranges; and Canada, France, and Germany are in the lowest range. Local government in Denmark stands out, claiming about 50 percent of total expenditures, which account for about 30 percent of GDP. Among the industrial countries, Australia is an outlier with local expenditures accounting for less than 3 percent of GDP.

Figure 5.1. Relative Importance of Local Governments as measured by expenditure share and employment share of general government



Source: Ivanyna and Shah, forthcoming.

Relative importance of local government is quite small and local government role in local economic development is quite weak in Australia ("roads and rubbish" only), India (largely ornamental), France and United Kingdom. In these countries local governments were seen in the past more as instruments of political participation rather than autonomous institutions for self-government and service provision. This view has been reshaped to give greater autonomy to local governments in municipal services in recent years in UK and France. Local governments are relatively more important and play a moderate role in local economic development in Japan, Germany, Canada, USA and Brazil. In these countries, local governments have an exclusive role in municipal services but limited role in social services. The role of local government is expansive in Nordic countries (Denmark, Norway, Sweden and Finland), Switzerland and China. In Nordic countries, local governments act as the primary agent of citizens and provide a broad role in support of a client-oriented welfare state. For example, in Finland, local governments assume a predominant role in social services (Moisio, Loikkanen, Oulasvirta, 2010). In Switzerland cantons (higher order of local governments) enjoy autonomy not only in fiscal matters but also in such areas as immigration, citizenship, language and foreign economic relations. China affords its local governments one of the strongest role in local economic development. Local governments below provincial level employ 89% of the public workforce and command 51% of public expenditures. A unique feature of local government in China is that local autonomy varies directly with success in local performance as measured by local economic development, service delivery and citizen satisfaction. Nordic countries, Switzerland and China appear to have local government role more consistent with the demands of new world economic order.

Some Lessons

Historical evolution and the current practice of local governance is instructive in drawing lessons for reform of local governance. There is great diversity in practice in local governance in industrial countries, but there are also some common strands. The diversity is in the institutional arrangements, which have evolved incrementally over a long period. This evolution has resulted in diverse roles for local governments and diverse relations with central governments across countries. In Nordic countries, local government serves as the primary agent of the people, whereas in Australia, that role is entrusted to state governments, and local government has a minimal role in local affairs.

There is no uniform model for local government size, structure, tiers, and functions across OECD countries. There are nevertheless a number of interesting common features. First, most countries recognize that finance must follow function to ensure that local governments are able to meet their responsibilities efficiently and equitably. Second, home rule is considered critical to meeting local expectations and being responsive to local residents. Therefore, local governments must have significant taxing, spending, and regulatory autonomy, and they must have the ability to hire, fire, and set terms of reference for employees without having to defer to higher levels of governments. Only then can local governments innovate in management by introducing performance-based accountability and innovate in service delivery by forging alternative service delivery arrangements through competitive provision, contracting, and outsourcing wherever deemed appropriate as done in Finland (see Moisio, Loikkanen and Oulasvirta, 2010). They can also facilitate a broader network of local governance and harness the energies of the whole community to foster better social outcomes. Third and most important, accountability to local residents has been the factor most critical to the success of local governance in industrial countries. This accountability is strengthened through democratic choice, participation, transparency, performance budgeting, citizens' charters of rights, and various legal and financing provisions that support wider voice, choice, and exit options to residents.

In conclusion, a synthesis of the conceptual literature suggests that the modern role of a local government is to deal with market failures as well as government failures. This role requires a local government to operate as a purchaser of local services, a facilitator of networks of government providers and entities beyond government, and a gatekeeper and overseer of state and national governments in areas of shared rule. Local government also needs to play a mediator's role among various entities and networks to foster greater synergy and harness the untapped energies of the broader community for improving the quality of life of residents. Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments. This view is also grounded in the history of industrial nations especially Nordic countries and ancient civilizations in China and India. Local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and regional governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule for improving the quality of life and social outcomes. The new vision of local governance (table 5.1) presented here argues for a leadership role by local governments in a multi-centered, multi-order, or multi-level system. This view is critical to creating and sustaining citizen-centered governance, in which citizens are the ultimate sovereigns and various orders of governments serve as agents in the supply of public governance. This view is also relevant for carving and sustaining a competitive edge in international economic relations as demonstrated by the recent experience of China. Empowering local governments and strengthening their role in local economic development ushered China in an era of sustained economic growth and lifting billions out of the poverty trap.

5.3 Structure and Size of Local Government

The fiscal federalism and public choice literature provides broad guidance on the structure of local government and assignment of responsibilities to local, metropolitan and regional governments. A synthesis of this literature suggests that the assignment of public services to local governments or to metropolitan or regional governments can be based on considerations such as economies of scale, economies of scope (appropriate bundling of local public services to improve efficiency through information and coordination economies and enhanced accountability through voter participation and cost recovery) and cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and budgetary choices about the composition of spending. The particular level of government to which a service is assigned determines the public or private or competitive production of the service in accordance with considerations of efficiency and equity. Large metropolitan areas with populations in excess of 1 million could be considered for subdivision into a first tier of municipal governments of smaller size responsible for neighborhood-type services and a second tier of metropolitan-wide government providing area-wide services. The first-tier governments could be directly elected, and elected mayors of these governments could form the metropolitan council at the second tier. Two-tier structures for metropolitan governance have been practiced in Melbourne, Australia; Vancouver, Canada; Allegheny county, Pennsylvania, United States; and Stockholm, Sweden.

In industrial countries, special-purpose agencies or bodies deliver a wide range of metropolitan and regional public services, including education, health, planning, recreation, and environmental protection. Such bodies can include library boards; transit and police commissions; and utilities providing water, gas, and electricity. These agencies deal with public services whose delivery areas transcend political jurisdictions and are better financed by loans, user charges, and earmarked benefit taxes, such as a supplementary mill rate on a property tax base to finance a local school board. If kept to a minimum, such agencies can exploit economies of scale in the delivery of services where political boundaries are not consistent with service areas. A proliferation of these agencies can undermine accountability and budgetary flexibility at local levels. Accountability and responsiveness to voters are weakened if members of special-purpose bodies are appointed rather than elected. Budgetary flexibility is diminished if a majority of local expenditures fall outside the control of local councils.

Private sector participation can also take a variety of forms, including contracting through competitive biddings, franchise operations (local government acting as a regulatory agency), grants (usually for recreational and cultural activities), vouchers (redeemable by local government with private providers), volunteers (mostly in fire stations and hospitals), community self-help activities (for crime prevention), and private nonprofit organizations (for social services). Thus, a mix of delivery systems is appropriate for local public services.

A Brief Overview of Practices

There are wide variations in the number of municipal governments, with as few as 74 in New Zealand and as many as 35,906 in the United States. Similarly, the median size of a municipal government jurisdiction in 1998 was smallest in Iceland (1,160 people) and largest in the United Kingdom (about 160,000). In a large majority of industrial countries, the average municipal government jurisdiction covers fewer than 20,000 people (see Boadway and Shah, 2009). This small size is seen to limit efficiency gains from economies of scale and scope and there has been a wave of consolidating smaller municipalities to create a larger size municipality in the European Union during the last decade. Finland in 1998, instituted a special grant program to promote such mergers. In the academic literature, there is yet no consensus on the optimal size of a general purpose local jurisdiction as the optimal size varies by type of services. McMillan (2008) argues that a population size of 10–20,000 may be appropriate. Whereas Loikkanen and Susiluoto (2006) in Finland's case find that a relatively smaller size (about 5–10,000) may be most efficient for welfare services. On the other hand, Aaltonen et al (2006) find that optimal local size jurisdiction falls in the range of 20–40,000. Aaltonen et al findings may be more relevant for most industrial countries (see also Moisio et al, 2010).

There is no uniform model in local spending responsibilities, except that property-oriented services are provided at the local level in almost all countries. In infrastructure, Australian local governments command 27 percent of total expenditures, compared with 62 percent in the United Kingdom and 47 percent and 41 percent in the EU and the OECD. People-oriented services show more variation. In education, there is no role for local government in Australia, but it takes up more than 60 percent of expenditure share at local levels in Canada, the United Kingdom, and the United States. In the OECD, it averages about 46 percent. In health, local governments have no role in Australia and the United Kingdom but a predominant role in Denmark (about 92 percent); EU and OECD average expenditure shares are 28 percent and 19 percent, respectively. Most industrial countries have significant higher-level intervention in social services and unfunded mandates to local governments in environmental protection.

Overall, local governments in Nordic countries perform the maximal range of local services, encompassing a wide range of people- and property-oriented services. Local governments in southern Europe and in North America fall in a median range and are more focused on property-oriented services. Australian local governments are engaged in the most minimal property-oriented services (primarily "roads and rubbish").

5.4 Financing Local Governments

Fiscal federalism literatures highlights four general principles requiring consideration in assigning taxing powers to various governments. First, the *economic efficiency* criterion dictates that taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the center. Subnational assignment of taxes on mobile factors may facilitate the use of socially wasteful "beggar thy neighbor" policies to attract resources to own areas by regional and local governments. In a globalized world, even central assignment of taxes on mobile capital may not be very effective in the presence of tax havens and the difficulty of tracing and attributing incomes from virtual transactions to various physical spaces. Second, *national equity* considerations warrant that progressive redistributive taxes should be assigned to the center, which limits the possibility of regional and local governments following perverse redistribution policies using both taxes and transfers to attract high-income people and repel low-income ones. Doing so, however, leaves open the possibility of supplementary, flat-rate, local charges on residence-based national income taxes. Third, the *administrative feasibility* criterion (lowering compliance and administration costs) suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. This criterion minimizes administrative costs as well as the potential for tax evasion. For example, property, land, and betterment taxes are good candidates for local assignment because local governments are in a better position to assess the market values of such assets. Fourth, the *fiscal need* or *revenue adequacy* criterion suggests that to ensure accountability, revenue means (the ability to raise revenues from own sources) should be matched as closely as possible with expenditure needs. The literature also argues that long-lived assets should primarily be financed by raising debt, so as to ensure equitable burden sharing across generations (Inman 2006). Furthermore, such large and lumpy investments typically cannot be financed by current revenues and reserves alone (see box 5.1).

These four principles suggest that user charges are suitable for use by all orders of government, but the case for decentralizing taxing powers is not as compelling as that for decentralizing public service delivery. This is because lower-level taxes can introduce inefficiencies in the allocation of resources across the federation and cause inequities among people in different jurisdictions. In addition, collection and compliance costs can increase significantly. These problems are more severe for some taxes than others, so the selection of which taxes to decentralize must be made with care, balancing the need to achieve fiscal and political accountability at the lower levels of government against the disadvantages of having a fragmented tax system. The tradeoff between increased accountability and increased economic costs from decentralizing taxing responsibilities can be mitigated by fiscal arrangements that permit joint occupation and harmonization of taxes as done in Canada and Finland to overcome fragmentation and by fiscal equalization transfers that will reduce the fiscal inefficiencies and inequities that arise from different fiscal capacities across regional and local governments.

Box 5.1. Key Considerations and Tools for Local Government Finances

Key Considerations

The overall objective of local governments is to maximize social outcomes for residents and provide an enabling environment for private sector development through efficient provision of public services. This requires that local financing should take into account the following considerations:

- Local government should limit self-financing of redistributive services.
- Business should be taxed only for services to businesses and not for redistributive purposes.
- Current period services should be financed out of current year operating revenues and future period services should be financed by future period taxes, user charges/fees, and borrowing.
- Residential services should be financed by taxes and fees on residents.
- Business services should be financed on site/land value taxes and user charges. Profit, output, sales, and moveable asset taxes may drive business out of the jurisdiction.

Tools for Local Finance

- *Local taxes* for services with public goods characteristics – streets, roads, street lighting
- *User charges* for services with private goods characteristics – water, sewerage, solid waste
- *Conditional, non-matching, output-based grants* from national/state-order governments for merit goods: education and health
- *Conditional matching grants* for spillovers in some services
- *Unconditional grants* for fiscal gap and equalization purposes
- *Capital grants* for infrastructure if fiscal capacity is low
- *Capital market finance* for infrastructure if fiscal capacity is high
- *Development charges* for financing growth with higher charges for developing land on local government boundaries
- *Public-private partnerships* for infrastructure finance but keeping public ownership and control of strategic assets
- *Tax increment financing districts* to deal with urban blight. For this purpose, the area should be designated for redevelopment and annual property tax revenues frozen at pre-vitalization levels. For a specified period, say 15-35 years, all tax revenues above base are used for redevelopment. Capacity improvements are undertaken through municipal borrowing/bonds against expected tax increments.

Source: Inman (2006) and Shah and Shah (2006), Boadway and Shah (2009).

The Practice: Local Revenues and Revenue Autonomy

Income taxes, property taxes, and fees are major revenue sources for local governments. In Belgium, Denmark, Finland, Germany, Iceland, Japan, Luxembourg, Norway, Sweden, and Switzerland, more than 80 percent of tax revenues are derived from taxes on personal and corporate incomes. In contrast, in Australia, Canada, Ireland, the Netherlands, New Zealand, the United Kingdom, and the United States, property taxes contribute more than 80 percent of local tax revenues. It should be noted, however, that the role of local governments is quite constrained in countries where property tax finance dominates due to limited productive potential of such taxes. Therefore OECD's call for a larger role of property tax finance in Finland may not be practicable (see Moisio et al, 2010). Austria, France, Greece, Italy, Portugal, and Spain rely on a mix of local tax sources, with Spain drawing about 40 percent of tax revenues from sales taxes. For the EU as a whole, income taxes dominate, followed by property taxes, sales taxes, and fees. On average in industrial countries, 50 percent of local revenues come from taxes, 20 percent from user charges, and 30 percent from transfers from higher levels (see McMillan 2008).

Intergovernmental finance is relatively less important in Austria, Canada, Denmark, Finland, New Zealand, and Sweden, whereas in most OECD countries the share of grant-financed local expenditures is quite large. This large share of grants indicates that in many OECD countries, local governments typically perform agency functions for higher-level governments and have only a limited range of locally determined responsibilities. General-purpose, formula-based grants using fiscal capacity and need factors dominate in most OECD countries, with the exception of New Zealand, and the United States. In those three countries, specific-purpose transfers assume greater importance in local finances. In Finland, expenditure needs determined on the basis of sector specific indicators are compensated by a general block grant with no conditions on the use of funds (see Moisio et al, 2010).

In most countries, airports, parking, water, sewerage, and garbage collection are predominantly financed by fees, whereas social services are primarily financed from general tax revenues and grants. Infrastructure finance relies on a mix of sources that include own-source revenues and reserves, charges, fiscal transfers, borrowing, and public-private partnership arrangements. In most countries, significant help is available from higher-level governments in facilitating access to the credit market for local governments

5.5 Reform of Central-local fiscal transfers to strengthen local autonomy while enhancing incentives for accountability

In financing local governments, industrial countries place a significant emphasis on general purpose equalization transfers. These transfers are typically financed by the central government with a few exceptions. As an example of such an exception, in Finland, while the expenditure need component of the fiscal equalization is financed by the central government, the fiscal equalization component of the equalization program is based on Robin-Hood or solidarity type of transfers where richer local jurisdictions contribute to the pool and the poorer jurisdictions receive funds from this pool (see Moisio, Loikkanen and Oulasvirta, 2010). These latter type of equalization transfers represent the ideal form of such transfers as contributions of richer jurisdictions are recognized and overall pool is subject to discipline based upon the consensus of donors and recipients. Such an internal discipline is lacking in wholly centrally financed transfers as the latter transfers depend on the whims of the central government. This creates incentives for local politicians to lobby the central government for ever higher levels of such transfers and also undermines local government accountability to local residents with implicit incentives for lower tax effort. These lobbying efforts have resulted in highly complex allocation criteria as prevalent in central-local equalization transfers in Australia and Netherlands making the whole system not only opaque but also possibly unjust. Expenditure need equalization adds a significant layer of complexity and controversy in these transfers. Ideally, one may aim for a simpler solidarity type approach to fiscal capacity equalization to a standard arrived by political consensus among all donors and recipients as done in Finland. Expenditure needs equalization could be achieved through output-based specific purpose transfers.

Specific purpose (conditional) transfers in most industrial countries (with notable exception of Nordic countries) are typically not well structured. These are ad hoc transfers for specific functions with requirements for verification of grant financed expenditures. They undermine local autonomy and distort local priorities if, as usually is the case, there are conditions on spending and fungibility of funds is not feasible as would be the case for spending that receives low priority in local allocation choices. Nordic countries, especially Denmark and Finland, have improved upon the traditional design of such conditional grants at least in fairness of allocation criteria by using a "standard cost" approach. This approach is desirable but it still misses the most important ingredient – incentives for results based accountability. Shah (2006, 2009) has argued that output based transfers (or performance oriented grants) that link grant finance with local service delivery performance while allowing local government to spend the transfer monies as they please, would preserve local autonomy while strengthening bottom up accountability. A few illustrative examples of such transfers are presented below.

Output based operating transfers for setting national minimum standards for merit goods (education, health, social welfare and infrastructure).

(a) *Output based school grants to encourage competition and innovation in education*. Output based grants create incentives regime to promote the results based accountability culture. Consider the case where the national government aims to improve access to education by the needy and poor as well as enhance quality of such education. A commonly practiced approach is to provide grants to government schools through conditional grants. These grants specify the type of expenditures eligible for grant financing, for example, books, computers, teachers' aides etc and also financial reporting and audit requirements. Such input conditionality undermines budgetary autonomy and flexibility without providing any assurance regarding the achievement of results. Such input conditionality, in practice, is difficult to enforce as there may be significant opportunities for fungibility of funds. Experience has also demonstrated that there is no one-one link between increase in public spending and improvement in service delivery performance. To bring about accountability for results, consider an alternate, output based design of such grants. Under the alternate approach, national government allocates funds to local authorities based upon school age population. The local authorities in turn pass these funds to both government and non-government providers based upon school enrollments. Conditions for receipt of these grant funds for non-government providers are that they must admit students on merit and provide tuition subsidy to students whose parents do not have sufficient means to afford such fees. Conditions for the continuation of funds for all providers will be to improve or at the minimum maintain baseline achievement scores on standardized tests, improve graduation rates and reduce dropout rates. Lack of compliance with these conditions will invite public censure and in the extreme case a threat of discontinuation of funds with perpetual non-compliance. In the meanwhile reputation risks associated with poor performance may lead to reduced enrollments and associated reduction in grant funds through parental choices. There are no conditions on the use of funds and schools have full autonomy in the use of grant funds and retain unused funds. Such grant financing would create an incentive environment for both government and non-government schools to compete and excel to retain students and establish reputation for quality education as in the final analysis it is the parental choice that would determine available grant financing to each school. Such an environment is particularly important for government schools where typically staff have life-long appointments and financing is assured regardless of school performance. Budgetary flexibility and retention of savings would encourage innovation to deliver quality education. Thus output based grants preserve autonomy, encourage competition and innovation while bringing strict accountability for results to residents. This accountability regime is self enforcing through consumer (parental choice in the current example) choice. Such a school financing regime is especially helpful for countries where several local jurisdictions are plagued with poor quality of teaching and worse teacher absenteeism or lack of access to education in rural areas. The incentive regime provided by results based financing will create market mechanism to help overcome these deficiencies over time.

(b) *Output based grants for local health financing*. A similar example of such a grant in health care would allocate funds to local authorities based upon weighted population by age class with higher weights for senior citizens (65 years and over) and children (under 5 years). The distribution by local authorities to providers would be based upon patient use. Minimum standards of service and access to health care will be specified for the eligibility to receive such transfers.

(c) *Output based grants for social welfare*. Such grants would provide matching assistance to local authorities based upon the relevant service population e.g. elderly without care, single mothers, orphans etc. Matching rate would vary with the fiscal capacity of the local jurisdiction with lower matching rate for richer jurisdictions.

(d) *Output based transfers for road maintenance*. Such a grant would be based on classification of roads by types and traffic use and provide per kilometer grants differentiated by the type of road classification. Minimum standards of up-keep service for such roads will be specified and future grant releases will depend upon local authorities certifying those standards are being met and providing information on road conditions and use.

Lessons from the Practice of Intergovernmental Fiscal Transfers

Review of international practices yields a set of practices to avoid and a set of practices to emulate. A number of important lessons also emerge (table 5.2).

Table 5.2. Principles and better practices in grant design

Grant objective	*Grant design*	*Examples of better practices*	*Examples of practices to avoid*
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, tax-base sharing	Tax abatement and tax-base sharing (Canada, Finland, Thailand)	Deficit grants, wage grants (China), tax by tax sharing (China, India)
Reduce local/ regional fiscal disparities	General nonmatching fiscal capacity equalization transfers	Fiscal equalization with explicit standard that determines total pool as well as allocation (Canada, Denmark, Finland and Germany)	General revenue sharing with multiple factors (Brazil and India); fiscal equalization with a fixed pool (Australia, China)
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spill-out of benefits	Grant for teaching hospitals (South Africa)	Closed-ended matching grants
Set national minimum standards	Conditional nonmatching output-based block transfers with conditions on standards of service and access	Road maintenance and primary education grants (Indonesia before 2000) Education transfers (Brazil, Chile, Colombia). Health transfers (Brazil, Canada), school finance, health and social transfers in Finland, “standard cost” allocation criteria in Finland	Conditional transfers with conditions on spending alone (most countries), pork barrel transfers (USA), ad hoc grants
	Conditional capital grants with matching rate that varies inversely with local fiscal capacity.	Capital grant for school construction (Indonesia before 2000), highway construction matching grants to states (United States)	Capital grants with no matching and no future upkeep requirements
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance (Canada before 2004, Finland)	Ad hoc grants
Provide stabilization and overcome infrastructure deficiencies	Capital grants, provided maintenance possible.	Capital grants with matching rates that vary inversely with local fiscal capacity	Stabilization grants with no future upkeep requirements

Source: Adapted from Boadway and Shah, 2009

Negative Lessons: Types of Transfers to Avoid

Policymakers should avoid designing the following types of intergovernmental grants:

- Grants with vaguely specified objectives.
- General revenue–sharing programs with multiple factors that work at cross purposes, and undermine accountability and do not advance fiscal efficiency or fiscal equity objectives. Tax decentralization or tax-base sharing offer better alternatives to a general revenue– sharing program, as they enhance accountability while preserving subnational autonomy.
- Grants to finance subnational deficits, which create incentives for running higher deficits in future.
- Unconditional grants that include incentives for fiscal effort. Improving service delivery while lowering tax costs should be public sector objectives.
- Input- (or process-) based or ad hoc conditional grant programs, which undermine local autonomy, flexibility, fiscal efficiency, and fiscal equity objectives.
- Capital grants without assurance of funds for future upkeep, which have the potential to create white elephants.
- Negotiated or discretionary grants in a federal system, which may create dissention and disunity.
- One size fits all grants to local governments, which create huge inequities.
- Grants that involve abrupt changes in the total pool and its allocation.

Positive Lessons: Principles to Adopt

- Policymakers should strive to respect the following principles in designing and implementing intergovernmental transfers:
- Keep it simple. In the design of fiscal transfers, rough justice may be better than full justice, if it achieves wider acceptability and sustainability.

- Focus on a single objective in a grant program and make the design consistent with that objective. Setting multiple objectives in a single grant program runs the risk of failing to achieve any of them.

- Introduce ceilings linked with macro indicators and floors, to ensure stability and predictability in grant funds.

- Introduce sunset clauses. It is desirable to have the grant program reviewed periodically – say, every five years – and renewed (if appropriate). In the intervening years, no changes to the program should be made, in order to provide certainty in budgetary programming for all governments.

- Equalize per capita fiscal capacity to a specified standard in order to achieve fiscal equalization. Such a standard would determine the total pool and allocations among recipient units. Calculations required for fiscal capacity equalization using a representative tax system for major tax bases are doable for most countries. In contrast, expenditure need equalization requires difficult and complex analysis, inviting much controversy and debate; as desirable as it is, it may not therefore be worth doing. In view of this practical difficulty, it would be best to deal with fiscal need equalization through output-based sectoral grants that also enhance results-based accountability. A national consensus on the standard of equalization is critically important for the sustainability of any equalization program. The equalization program should not be looked at in isolation from the broader fiscal system, especially conditional transfers. The equalization program would be strengthened by the addition of a sunset clause and provision for formal review and renewal. For local fiscal equalization, one size does not fit all.

- In specific-purpose grant programs, impose conditionality on outputs or standards of access and quality of services rather than on inputs and processes. This allows grantors to achieve their objectives without undermining local choices on how best to deliver such services. Most countries need to establish national minimum standards of basic services across the nation in order to strengthen the internal common market and economic union.

- Recognize population size class, area served, and the urban/rural nature of services in making grants to local governments. Establish separate formula allocations for each type of municipal or local government.

- Establish hold harmless or grandfathering provisions that ensure that all recipient governments receive at least what they received as general-purpose transfers in the pre-reform period. Over time, as the economy grows, such a provision would not delay the phase-in of the full package of reforms.

- Make sure that all stakeholders are heard and that an appropriate political compact on equalization principles and the standard of equalization is struck. Politics should be internalized in these institutional arrangements. Arms-length institutions, such as independent grant commissions, are not helpful, as they do not allow for political input and therefore tend to opt for complex and nontransparent solutions.

- Moving from a public sector governance culture of dividing the spoils to an environment that enables responsive, responsible, equitable and accountable governance is critical. Doing so requires exploring all feasible tax decentralization options, instituting output-based operating and capital fiscal transfers, establishing a formal fiscal equalization program with an explicit standard of equalization, and ensuring responsible access to borrowing.

5.6 Budgetary Institutions for Local Fiscal Discipline

Having greater local autonomy also poses some risks for national macroeconomic management and a large number of countries have in recent decades grappled with a framework for fiscal discipline at the local level. These efforts attempt to mitigate the so-called tragedy of commons associated with common pool resources allocated and distributed by the central government. A stylized view of these approaches is presented below.

1. *Citizen-voter based discipline – direct democracy provisions*. This is the approach adopted by Switzerland, where new taxes and expenditures and borrowing by cantons and communes is restricted to capital projects that can be financed on a pay as you go basis and requires a popular referendum for approval. A variation of this approach is also imposed on local governments by three states in the USA and four provinces in Canada. People based discipline works best in societies that have conservative fiscal values as in Switzerland.

2. *Market-based discipline*. Market based discipline is exercised through rating agencies which rate local governments as well as their marketable financing instruments such as municipal bonds. Finland and Canada rely heavily on this channel to discipline their local governments. Market based discipline works best when rating agencies act with professionalism

and integrity and avoid conflict of interest and when there is no possibility (implicit or explicit) of a central government bailout. Recent US experience has shown that such conditions may not be hold in real life.

3. *Discipline through intergovernmental coordination*. If all orders of government are involved in jointly formulating and implementing fiscal policy, then moral suasion and peer pressure can be brought to reign in on members that do not comply. Several countries follow this approach. In Australia, National Loan Council monitors fiscal health of all members and serves as a coordinating agency for public borrowing. Austria, Belgium, Canada and Spain have set up intergovernmental forums to coordinate response to fiscal policy issues.

4. *Soft controls*. These are the principles, codes of conduct or process and reporting requirements to ensure greater transparency and accountability in budgeting. Most industrial countries (e.g. Canada, Denmark, Finland, Germany and Norway) have established fiscal reporting and external auditing requirements. Most also follow golden rule for borrowing. UK has established principles and processes of sound fiscal management at the local level and has also established an independent audit commission for local governments.

5. *Hard controls.* Following the European Union Growth and Stability pact, a large number of countries have enacted budget balance requirements (see Table 5.3) numerical fiscal rules imposing limits on wages, expenditure and debt (see table 5.4). Non-compliance with these rules invites specific legal sanctions in Brazil (strictly imposed) and the European Union (mostly ignored in practice)

Fiscal Responsibility Legislation. The purpose of such legislation is to provide a comprehensive framework for fiscal discipline and fiscal sustainability. Such legislation may embody one or more of the elements of budgetary discipline discussed above. New Zealand, Brazil, Colombia, Ecuador, Peru and Argentina have used this framework with some success in bringing about local fiscal discipline.

Table 5.3. Budget balance requirements in selected countries

	Coveraged Budget			Duration		carry-over	Application / Implementation		
	only current	current +capital	+off-budget items	annual	multi-annual	permitted	imposed	negotiated binding	self-imposed
Industrial Countries									
Australia					x			x	
Austria		x	x (state)		x			DSP	
Canada	x				x (local)	x	x (local)		x (state)
Denmark	x (local)			x			x		
Finland	x (local)				x		x		
France	x			x			x		
Germany	x (state)			x			x (local)		x (state)
Italy	x (regions)			x		x	DSP		
Japan	x (local)			x					x
Netherlands	x (local)				x	x (local)	x (local)		
New Zeland	x (local)				x			x	
Norway	x (local)				x		x		
Portugal		x (local)		x			x		
Spain		x	x		x	x	x (local)	DSP	
Sweden	x (local)			x			x		
Switzerland	x			x					x
United Kingdom	x				x		x		
United States	x			x					x
Developing Countries									
Argentina	x				x				FRL
Brazil	x					x	FRL		
Chile	x				x			x	
Colombia	x			x			FRL		
Ecuador	x				x		FRL		

DSP = Domestic Stability Pact

FRL = Fiscal Responsibility Law

Table 5.3. (continued)

	Coveraged Budget			Duration		carry-over	Application / Implementation		
	only current	current +capital	+off-budget items	annual	multi-annual	permitted	imposed	negotiated binding	self-imposed
Developing Countries									
India	x				x				FRL
Korea		x		x			x		
Peru	x				x	x	FRL		
Turkey		x (local)					x		
Transition Countries									
China	x								
Croatia	x								
Czech Republic		x		x			x		
Estonia	x								
Hungary	x (local)								
Kazakhstan	x								
Poland		x	x	x			x		
Russia	x								
Slovenia	x								

DSP = Domestic Stability Pact

FRL = Fiscal Responsibility Law

Table5. 4. *Subnational borrowing controls in selected countries*

	Market	Rules-Based Control			Administrative Control	Prohibition	
	Discipline	limit on debt	limit on debt service	specific purpose	Prior Approval	domestic	abroad
Industrial Countries							
Austria				x	x		
Belgium					x		
Canada	x			x (local)	x (local)		
Denmark				x		x (local)	
Finland	x						
France				x (local)			
Germany				x	x		
Greece					x (local)		
Ireland					x (local)		
Italy		x	x	x			x
Japan					x		
Norway				x (local)	x		
Portugal				x (local)			
Spain			x	x	x		
Sweden				x			
Switzerland				x			
United Kingdom				x (local)	x (local)		
United States				x			
Developing Countries							
Argentina		x		x			
Bahamas						x	x
Bolivia		x	x	x	x		
Brazil		x	x	x			
Chile				x	x		
Colombia		x	x	x			
Costa Rica				x	x		
Ecuador		x	x	x	x		
El Salvador				x	x		
Ethiopia					x		x
Guatemala				x	x		
Guyana				x	x		
Honduras				x	x		
India		x	x	x			
Jamaica					x		
Korea				x	x		
Mexico	x				x (local)		
Panama				x	x		
Paraguay				x	x		
Peru		x	x	x	x		
Suriname						x	x
Thailand						x	x
Trinidad and Tobago				x	x		
Turkey					x (local)		

Table 5.4. (continued)

	Market	Rules-Based Control			Administrative Control	Prohibition	
	Discipline	limit on debt	limit on debt service	specific purpose	Prior Approval	domestic	abroad
Transition Countries							
Albania		x					x
Armenia			x				x
Azerbaijan						x	x
Belarus			x				
Bosnia						x	x
Bulgaria		x					
China				x			
Croatia				x	x		
Czech Republic	x						
Estonia		x	x	x			
Georgia					x		x
Hungary			x	x (local)			
Kazakhstan		x	x	x			x
Kyrgyz Republic		x			x		
Latvia		x			x		
Lithuania		x			x		
Poland			x		x		
Romania			x				
Russia		x	x	x			x
Slovakia	x						
Slovenia		x		x			
Tajikistan						x	x
Ukraine					x		x
Uzbekistan						x	x

Source: Crivelli and Shah (2009)

5.7 A Framework for Monitoring and Evaluating Local Government Performance

Traditional literature has focused on subsidiarity principle to ensure that public sector decision moves closer to people. It assumes that once decision making moves closer to people, voting by ballots and voting with feet will ensure accountable local governance. However such mechanisms may work imperfectly and central government monitoring of the financial and general operations of local authorities may be needed. In the event, local authorities are fully self-financed, accountability mechanisms are expected to work well and therefore need for external oversight may be limited. When local authorities are predominantly financed by higher level transfers, a strong rationale emerges for a framework for oversight of local authorities to balance autonomy and accountability concerns. For citizens at large such a framework is needed to ensure that local authorities face an incentive environment that is compatible with focus on service delivery and bottom-up accountability and limiting the agents' ability to indulge in opportunistic behaviors. Shah and Shah (2006) have advanced the following three principles to decide on specific criteria for evaluating local government performance.

Responsive and fair governance. This principle aims for governments to do the right things – that is, to deliver services consistent with citizen preferences and to safeguard the interests of the poor, needy and disadvantaged groups.

Responsible governance. The government should also do it right – that is, manage its fiscal resources prudently. It should earn the trust of residents by working better and costing less and by managing fiscal and social risks for the community. It should strive to improve the quality and quantity of and access to public services. To do so, it should benchmark its performance with the best-performing local government. Table 5.5 provides examples of indicators that can be used for such benchmarking in police protection and transportation services.

Table 5.5. Performance Benchmarks

	Police	**Transportation**
Cost	Per capita expenditure	Per capita expenditure
Workload	Average number of police calls	Lane miles to be constructed and maintained
Efficiency	Average cost per incident	Annual maintenance cost per lane mile
Quality	Percent of cases cleared	Percent of lane miles in good repair
Quality of life	Incidence of violent crimes	Ease of commute and pothole free of roads, traffic accidents and travel time delays due to congestion

Accountable governance. A local government should be accountable to its electorate. It should adhere to appropriate safeguards to ensure that it serves the public interest with integrity. Legal and institutional reforms may be facilitate local governments' ability to deal with accountability between elections – reforms such as a citizen's charter and a provision for recall of public officials.

Table 5.6 provides specific criteria for evaluating individual local government performance and ranking of these governments. The specified criteria embodies process, institutions and outcome measures. Overall the framework ensures that local governments have freedoms with accountability.

Table 5.6. A Framework for Monitoring and Evaluating Local Governance

Responsive and fair governance	*Responsible governance*	*Accountable governance*
• Has subsidiarity and home rule • Has direct democracy provisions • Has budget priorities consistent with citizens' preferences • Specifies and meets standards for access to local services • Improves social outcomes • Offers security of life and property • Offers shelter and food for all • Has clean air, safe water, and sanitation • Has a noise-free and preserved environment • Offers ease of commute and pothole-free roads • Has primary school at a walking distance • Has acceptable fire and ambulance response times • Has libraries and Internet access • Has park and recreation programs and facilities	Follows due process: • The principle of ultra vires or general competence or community governance • The procedure bylaw • Local master plans and budgets • Zoning bylaws and regulations • Funded mandates Is fiscally prudent: • Operating budget in balance • Golden rule for borrowing • New capital projects that specify upkeep costs and how debt is to be repaid • Conservative fiscal rules to ensure sustainable debt levels • Major capital projects that are subject to referenda • Maintenance of positive net worth • Commercially audited financial statements Earns trust: • Professionalism and integrity of staff • Safeguards against malfeasance • Streamlined processes and e-governance • Complaints and feedback acted on • Honest and fair tax administration • Strict compliance with service standards • Citizen-friendly output budgets and service delivery performance reports • Participatory budgeting and planning	Lets the sunshine in: • Local government bylaw on citizens' right to know • Budgetary proposals and annual performance reports posted on the Internet • All decisions, including the costs of concessions, posted on the Internet • Value for money performance audits by independent think tanks • Open information and public assessment Works to strengthen citizen voice and exit: • Citizens' charter • Service standards • Requirements for citizens' voice and choice • Sunshine rights • Sunset clauses on government programs • Equity- and output-based intergovernmental finance • Citizen-oriented performance (output) budgeting • Service delivery outputs and costs • Citizens' report card on service delivery performance • Budget, contracts, and performance reports defended at open town hall meetings • All documents subjected to citizen-friendly requirements • Open processes for contract bids • Mandatory referenda on large projects • Steps taken so that at least 50 percent of eligible voters vote

(continues on the next page)

(Continues)	Works better and costs less: • All tasks subjected to alternative service delivery test—that is, competitive provision involving government providers and entities beyond government • Financing that creates incentives for competition and innovation • Comparative evaluation of service providers • Public sector as a purchaser through performance contracts but not necessarily a provider of services • Managerial flexibility, but accountability for results • No lifelong or rotating appointments • Task specialization • Budgetary allocation and output-based performance contracts • Activity-based costing • Charges for capital use • Accrual accounting • Benchmarking with the best • General administration costs subjected to public scrutiny • Boundaries that balance benefits and costs of scale and scope economies, externalities, and decision making • Boundaries consistent with fiscal sustainability	• Citizens' boards to provide scorecard and feedback on service delivery performance • Provisions for popular initiatives and recall of public officials • Bylaw on taxpayer rights

Source: Shah and Shah (2006, 2007)

International Practices

The above framework has not been applied in its entirety anywhere in the world. But a number of the elements presented here are practiced in industrial countries and selected developing countries. Most industrial countries require due process provisions and sound public financial management principles are adhered to. In addition, monitoring of fiscal stress has received enhanced attention.

Monitoring fiscal stress – selected examples

State of Michigan, USA – 10-point Scale Fiscal Stress Indicator. The State of Michigan monitors local government fiscal health using the point ten point scale: Population Growth (2 years); Real Taxable Value Growth (2 years); Large decrease in real taxable value; General Fund Expenditures as a percent of taxable value; General Fund Operating Deficit; Prior General Fund Operating Deficits; General Fund balances as a percentage of General Fund revenues; Current year deficit in a major fund; Previous year deficit in a major fund; and General long term debt as a percentage of real taxable value.

State of Ohio, USA – Fiscal Watch program. Ohio monitors fiscal health of its local government and those in precarious fiscal health are placed under state watch following two classifications: (a) *Fiscal Watch list*: A local government is placed under this list if deficit exceeds 8.3% of revenues. All local governments placed under this list are obligated to follow workouts suggested by the state auditor; and (b) *Fiscal Emergency list*: A local government under extreme fiscal distress is placed on this list. To qualify, a local government must be with more than 30 day default on debt obligations and/or payment of salaries or overdue amounts exceed one-sixth of previous year revenues. A local government on this list is placed under a state appointed control board that manages its finances until the local government is brought to fiscal health.

Colombia Traffic Light System for Local Debt. Colombia has adopted fiscal rules to distinguish local governments in good fiscal health from those requiring central government attentions. It uses a traffic light system as follows: (a) Green light – local governments with healthy finances. These are local governments whose interest payments to savings ratio is less than 40% and ratio of debt to current income is less than 80%; (b) Yellow Light – local governments with moderate concerns about their fiscal health. Local governments that have ratio of interest payments to savings in the range of 40–60% qualify for this list. Central government provides advisory assistance to these local governments; and (c) Red Light – local governments in financial distress. A local government is placed on this list if its ratio of interest payments to savings exceeds 60% and its debt to current income exceeds 80%. All local governments on this list are placed under local government oversight.

The Practice of Fiscal Rules For An Early Warning System of Fiscal Stress. A number of countries have introduced numerical fiscal rules as early warning signs. For example, Russia requires that ratio of debt to revenues be less than 30% for oblasts and 15% for rayons. Limiting debt service to revenues is mandated at less than 25% in Italy and Spain, less than 20% in Japan and 15% in

Russia. Several other countries e.g. Brazil places limits on borrowing as a percent of revenues.

5.8 Concluding Remarks

This paper has reflected on the unfinished agenda for local government reform for the next decade. Broad contours of the reform include freeing local governments from shackles of centralized control so as to enable them to assume a leadership role in improving economic and social outcomes for local residents. This leadership role requires local governments to assume a catalyst's role in directing and coordinating governmental (including central government) and non-governmental agencies and networks to local economic development. Local governments would be in a position to play this role if their responsibilities are determined by home rule and community governance principles and they have adequate access to revenues from own sources or they can piggyback on central tax bases. In addition to strengthen their accountability to local residents not only finance should follow function but intergovernmental finance should be structured such as to strengthen local autonomy while enhancing results based accountability. There is also need for reform of the budgetary institutions so that all orders of government are bound by a common framework of fiscal responsibility, integrity, fiscal discipline and fiscal sustainability. There should also be a framework to ensure that local government performance is measured and monitored for compliance with the principles of responsive and fair, responsible and accountable governance.

Our survey of the literature suggests that local governance in most industrial countries does not fully correspond to the governance principles enunciated here or even to the needs of economic success in the information age. There are only few exceptions and these are found mostly in Nordic countries especially in Finland. Other industrial countries would be well advised to follow the Finland lead in adapting local governance to the needs of the 21st century.

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Chapter 6

The Finnish Model – Which way forward?

Antti Moisio (Ed.)

Each author was asked to briefly comment on the Finnish situation. In order to be able to do this, the authors were sent a recent report that describes Finnish local government (Moisio, Loikkanen and Oulasvirta 2010). These comments are presented in this chapter.

6.1 Comments on the Finnish Model: Camila Vammalle and Claire Charbit[1]

Finland is one of OECD's most decentralized countries (sub-central governments represent 40% of public spending and 30% of public revenues, well above the OECD average of 26% and 16% respectively), and the Finnish municipalities are responsible for providing essential public services, such as primary and specialized health care, social services, education services, etc. But today's socio-economic forces are challenging the capacity of Finland's central and sub-central governments to deliver quality public services effectively and efficiently. This is due to two main demographic factors. First is territorial migration, where municipalities in the Northern and Eastern regions are losing population as younger people move to urban centers, and the aged who remain are requiring more specialized services. The second is an ageing population, which puts a strain on service delivery. Since the migrating population tends to be youth or younger generations, the human capital pool available to provide services in the regions is shrinking. Together, these two phenomena result in a double problem, since: a) there will be fewer public sector workers to deliver services and pay taxes, and b) as municipal workers retire, they will be demanding the services they once provided, thereby adding to already increasing demand and forecasted

[1] The authors would like to thank Maria Varinia Michalun for her inputs and comments on these pages.

expenditure. Of course, this is compounded by the impact of the recent financial and economic crisis, as it puts an additional strain on municipal finances.

Faced with similar challenges, several OECD countries are seeking to increase the size of their administrative units, and/or create or reinforce a regional level of government, which would handle responsibilities where a critical mass is needed to increase effectiveness, such as health care or regional policy.[2] For example, in 2007, Denmark carried out a Local Government reform aiming at improving the quality of public goods provided by sub-national governments while ensuring their sustainable provision. This reform consisted in increasing municipalities' size (municipalities were obliged to merge to achieve a minimum population requirement), and reinforcing the regional level, replacing the 16 existing counties by 5 regions which assumed responsibilities such as health care and regional development. In some countries such as the Eastern European ones, the emergence of a regional level has also been encouraged by the allocation system of the EU Structural Funds, which is based on NUTS 2 regions. This triggered the creation of regions in countries such as the Czech Republic (1993 Constitution) or Poland (which created 16 regions in 1999). Some countries have allowed a differentiation in sub-national administrative structures, as it may be seen as more appropriate than a single "one-size-fits-all" structure. In Sweden for example, there has been a gradual, bottom-up regionalization process, where the central government did not impose a single model on the counties. This resulted in a rather heterogeneous administrative map, with three types of regions: a first type with directly elected regional councils, a second type with counties forming regional co-ordination bodies which are indirectly elected, and a third type where there are no regional bodies and where the central government intervenes through deconcentrated agencies. This experience highlights several pros and cons of asymmetric decentralization: on the one hand, it allowed a smooth decentralization process on a learning-by-doing basis, with the possibility to learn from the results, and positive experiences leading to "reform spillovers". In addition, it allows tailoring different solutions for regions with different needs and capacities. On the other hand, there is a risk of creating a complex and heterogeneous system in which accountability mechanisms are unclear and the credibility of the regional level is limited.[3]

As other OECD countries, Finland is searching for a way to secure the sustainability of its local governments and of the decentralized provision of basic public services by exploring territorial organization reforms. In 2007, Finland

[2] See: OECD (2010), Regional Policy in OECD Countries, Preliminary document prepared for the Territorial Development Policy Committee, GOV/TDPC(2010)1, OECD, Paris.

[3] For more information on the Swedish case, please refer to: OECD (2010), OECD Territorial Reviews: Sweden, OECD Publishing, Paris.

started implementing the PARAS reform, which aims at creating economies of scale by encouraging voluntary municipal mergers and municipal cooperation areas for public service delivery. Given the high degree of municipal autonomy in Finland, and the country's tradition of consensus it was not possible to use threats or sanctions to bind municipalities in implementing the reform (as was the case in Denmark, where municipalities were given one year to get into a voluntary merger, and if they did not comply, the central government could impose the merger). Municipalities therefore could choose between merging or joining larger cooperation areas, but financial incentives were used to encourage municipalities to select the merging option. Payments were provided for merging municipalities in function of three factors: the timing of the merger (the earlier, the greater the amount received), the number of municipalities involved (the greater the number, the larger the amount), and the population (higher rewards were given to municipalities which reached 20,000 inhabitants, and the amounts were greater the smaller the initial population of the merging municipalities). Still, despite these one-off payments, it is not obvious that municipalities really have incentives to merge. Indeed, the process of merging is costly, so it may absorb at least part of this financial benefit. Besides, given the equalization structure, small municipalities which face higher costs for providing public services are compensated through higher grants received from the central government, and can thus provide the same level and quality of public services as larger municipalities. The incentives embedded in the equalization mechanism should therefore be modified so that smaller municipalities have an incentive to improve their cost efficiency, for example by merging or joining a cooperation area. The PARAS reform would also benefit from setting clear targets for the mergers (population of the new municipality, total number of municipalities to be reached, clear deadline to carry out the mergers, etc.), and clear guidelines for the cooperation areas (which services should be transferred, to which institution, etc.).

Finland is also evaluating the relevance of reinforcing a regional level of government.[4] In spite of an apparently homogenous administrative structure (there are deconcentrated state bodies, regional councils, and hospital districts for example throughout the country), in practice, Finland has allowed a rather asymmetrical decentralization. In some regions, Pohjois-Pohjanmaa (Northern Ostrobothnia) for example, the administrative structure functions in the traditional fashion (standard division of tasks between municipalities and Regional Councils). In others, such as Central Finland where urban centers are strong and/or numerous (as in Jyvaskyla), these tend to overshadow the Regional Council, and are better positioned to lead some policies such as regional

[4] OECD (2010), OECD Public Governance Review of Finland: Working together to sustain success.

development (which is normally under the Regional Council's responsibility). The Aland Islands enjoy provincial autonomy. In the remote region of Kainuu, which faces specific challenges due to population scarcity and long distances, a regional self government experiment is ongoing (2003–2012), which gives the Regional Council a stronger role in multiple areas of administration (including financial management and service delivery). Finally, in greater Helsinki, a metropolitan structure would be most appropriate, and there are already plenty of co-operation and partnerships in place for the provision of key public services such as transportation, land use, housing, etc.

It would now be crucial to carry out an evaluation of these different experimentations and of the PARAS reform, in order to take an informed decision of what should be done next: extending the regional model as in Kainuu? Recognizing the asymmetric decentralization? Strengthening the municipal merger policy? Indeed, whatever the choice that will be made, it should be based on proper information and evaluation of existing practices. Then, implementing these choices will require reforms, and thus, relying on the relevant instruments which can facilitate these. A recent study of by the OECD[5] has underlined the specific challenges of public administration reforms and possible instruments which can facilitate them. Among these instruments, bundling several reforms together (such as territorial reform, allocation of roles and responsibilities and financing reforms) has helped several countries push public administration reforms through, as stakeholders may lose from some elements of the reform while benefiting from others, therefore being either indifferent or even supportive of the reform as a whole. In this regard, Finland may consider in the future, bundling the unfinished grants reform and the continuation of its local governments reforms together. This could for example allow reforming the equalization formula to give greater incentives to municipalities to seek efficiency gains, for example by merging and/or reinforcing cooperation agreements.

6.2 Comments on the Finnish Model: Jens-Blom Hansen

Based on the description of the Finnish situation given by Moisio et al. (2010) the Danish experience may be useful in four areas.

[5] Charbit, C., and Vammalle, C. (2010), "Modernising Government", in *Making Reform Happen: Lessons for the Future*, OECD Publishing, Paris.

Municipal amalgamations: A challenge for expenditure control

In 2007 the number of municipalities was reduced from 271 to 98 in Denmark. This was achieved by semi-voluntary amalgamations on a massive scale over just 1–2 years. 234 municipalities amalgamated into 65 new units. Only 33 were left intact. In Finland amalgamations are also on the political agenda, although much more time is allowed for the process. The Danish experience suggests that controlling municipal expenditure is difficult in this process.

This is due to three factors. First, amalgamating municipalities means closing down existing systems. This creates an incentive to "spend before closing time". No municipality seems to find it attractive to close down with unspent funds. Furthermore, many seem to find it relevant to protect local citizens from expected "unjust" measures from the future large municipality which may want to close down local institutions. One way to raise the political costs of doing so is to bring local institutions into tip-top shape before closing time. In Denmark, this incentive structure was anticipated by the central government which installed a number of restrictions to prevent overspending by the old municipalities (cf. above): Regulation of local capital and current spending levels, tax restrictions, and compulsory saving schemes. Nevertheless, the evidence suggests that overspending did take place (Blom-Hansen 2010).

Second, immediately after amalgamations have taken place, the new municipalities have to find a uniform service level on the basis of the previous municipalities' different service levels. In Denmark this averaging exercise was difficult. Local citizens were told that amalgamations were a good idea because the quality of local service would increase and so on. But citizens living in areas where the old municipalities had over-average service levels had to accept decreasing service levels unless municipal expenditure was to increase. On the one hand this is simple mathematics. On the other, it is politically very difficult. The political incentive was to aim for the highest common denominator. This incentive structure has not been investigated in detail, but it is probably one of the reasons why municipal expenditure increased dramatically after 2007.

Third, in Denmark one of the main arguments for amalgamations was that this would give rise to scale effects. Large municipalities were believed to be more efficient than small ones, especially in the administrative area (see e.g. Strukturkommissionen 2004: Ch. 11). This message was probably wrong. In the administrative area, large municipalities were not more efficient than small ones once differences in decentralization of administrative services to local institutions were controlled for (Blom-Hansen & Larsen 2005). In the various service areas a correlation between expenditure and municipality size could be demonstrated in the old structure, but this was probably spurious. Scale effects could be found at the level of institutions (e.g. schools, kindergartens), but there was no systematic relationship between the size of municipalities and the size of their institutions. What did matter for the size of local institutions was the degree of the individual municipality's urbanization (Blom-Hansen 2004a: 2004b). But urbanization would, of course, not change as a result of amalgamations.

So far, there is no evidence that the amalgamated municipalities in Denmark are more efficient than the old ones or more efficient than the municipalities which did not amalgamate. On the contrary, a study of the 2008 accounts showed rising administrative costs in the amalgamated municipalities (Krevi 2009). This should not be taken as evidence that no efficiency gains can be made from the reform. Amalgamations force municipalities to reconsider their organization, service standards, administrative routines, number and size of schools, kindergartens, old age homes, and so on. There are many potential learning effects here. But this is a reform effect, not a scale effect.

The Danish experience, in short, is that in economic terms municipal amalgamations carry considerable risks and no easy gains.

Municipal equalization schemes: Transparency or justice?

Finland and Denmark both have advanced systems for intermunicipal equalization that take into account differences in both expenditure needs and tax base. In both countries, equalization is on the political agenda, and reforms are often considered and sometimes implemented. The Danish experience suggests that this is an area of constant reform pressure and a futile search for a balance between fairness and transparency.

In contrast to the traditional system in Finland, Denmark has for a long time had a system that only involves the Ministry of Interior, not the sectoral ministries. In this sense, the preconditions for making a more coherent system should be present. But the record shows that the system is constantly debated. The following issues have been the most controversial ones in Denmark. First, measuring expenditure needs is not easy. In Denmark the greatest challenge has been to find good empirical indicators of social costs and to decide their importance relative to demographic costs. For the present (year 2010), social needs weigh 30.75 while demographic costs weigh 69.25 (Ministry of the Interior 2009b). This question is probably the thorniest issue in Denmark today. A number of municipalities feel that the system is so unfair that they have raised an "equalization rebellion". They have been so successful that an overhaul of the system has been promised for 2012.

Second, the question of which tax sources exactly to include in the tax base has been debated. Apart from income and property taxes, the municipalities also levy some minor taxes. But they are unevenly distributed among the municipalities.

So far, the general system only includes income and property taxes, but a special system for equalizing corporate income tax revenue has recently been installed. Third, the level of equalization is regularly debated. For the present, the general system equalizes 58 per cent of the differences in tax bases and expenditure needs, but there are special systems for municipalities in the Copenhagen region and very poor municipalities. Fourth, the relationship between matching grants and equalization is also constantly debated. Matching grants are seen to lead to suboptimal local decisions, but abolishing them requires more fine-grained equalization because the types of expenditure they help finance are not evenly distributed among the municipalities.

In addition to these technical questions, there are constant complaints that the equalization system is too complex and suffer from transparency and legitimacy problems. The challenge is that reducing complexity easily reduces the degree of fairness in the system, a dilemma well-known from other policy areas, e.g. tax policies.

In sum, the Danish experience suggests that equalization is a policy area where the status quo is constantly challenged. Due to its character as a zero-sum game between the municipalities it pits municipalities against each other and makes it an area difficult to handle for their associations. Furthermore, due to its technical complexity complaints of lack of transparency are likely to abound.

Macroeconomic policy: Central control vs. local autonomy

In all the Nordic countries local and regional governments are the implementing agencies of the welfare state. This means that municipalities and regions are responsible for a large share of public expenditure and income. This makes financial policy and macroeconomic control a challenge in all countries. Either this must be done on the basis of the relatively small central government budget, or some mechanism of involving the local and regional government sector must be found.

Denmark is probably the Nordic country where local and regional governments are subjected to macroeconomic control in the most systematic fashion. This is done through the system of annual economic negotiations between the central government and the association of local and regional authorities that is described earlier in the paper.

The Danish experience with this system is not easily summarized, but holds some lessons of potential value for Finland. The most general one is that finding the balance between central control and local autonomy is difficult. In principle the Danish system is elegant: A general revenue and expenditure guideline is set for the local and regional government sector which secures sound macroeconomic performance. At the same time local autonomy is respected because individual municipalities and regions may deviate from this guideline as long as it is kept at the collective level.

In practice, however, it is difficult. The most difficult problem is probably the rigidity which the system causes. Taxation is not adapted to local conditions because no mayor dares lower taxes since this would make the municipality more vulnerable to future constraints. In 2010 not a single municipality implemented tax cuts. This rigidity means that a pressure builds up in the system because municipalities experiencing an upwards expenditure pressure due to, say, the demographic development or the local employment condition are forced to cut down on welfare or seek assistance from the central government. As a partial acknowledgement of this problem the government set aside a “tax pool” of 500 mill. DKK for 2010. Municipalities which wanted to increase taxation could then seek permission with the Interior Ministry to increase their local income taxation. Central government taxes would then be reduced with the same amount so that overall taxation remained unchanged. In the end, 42 municipalities – that is, almost half of the 98 municipalities – sought a permission and, in total, they wanted to increase taxation by 2 bill. DKK, four times more than was possible. This example is indicative of the dilemma of involving local governments in macroeconomic control: What is left of the independent local taxation right in Denmark nowadays is a possibility for democratically elected mayors to apply for tax permission with a central government official.

This may be a deplorable situation from the perspective of local self-government. But under all circumstances it shows that involving local governments in macroeconomic control carries risks of creating counterproductive incentives. The rigidities in the Danish system mean that individual local authorities cannot adjust their own revenues. Faced with expenditure pressures they can either cut down local welfare or ask the central government for help. If the central government does not carefully follow a credible policy of not acting as a guarantor of last resort, it may be subjected to a pressure to bail out individual municipalities. So far, this situation has been avoided in Denmark because the central government has a precedent of responsible behavior when a municipality experiences a crisis. If a municipality cannot honor its obligations, it must seek exemption from the rule on overdraft facilities from the Interior Ministry. By tradition, to grant this exemption the ministry requires the municipality to present an economic recovery plan involving both tax increases and expenditure reductions (Juul 2006: 87–88). But this system is under pressure since local tax increases are no longer acceptable to the central government.

Is a regional level a good idea?

A big difference between the local government systems in Denmark and Finland is the status of the regional level. In Denmark, regions are – at least formally – independent political bodies directly elected by the regional citizens. In Finland, the regional level consists of municipal cooperations, so-called joint authorities. Although some attempts have been made in Finland to strengthen the regional level (e.g. the Kainuu-region), Finland is exceptional, since both Denmark, Norway and Sweden have regional governments. So based on the Danish experience, would it be a good idea to create regional governments in Finland?

As has been described in this chapter, Danish regions (before 2007: counties) have not had an easy life. The main problem seems to be that Danish citizens feel no particular allegiance to their region. When asked about their attachment to different geographical entities they systematically rank their region below their town, municipality and country (Kjær 2003). This lack of popular support makes it difficult for the regions to create a strong legitimacy base. This again means that their existence is mainly based on administrative efficiency. Since the local government reform in 1970 the main *raison d'être* of the regions/counties has been the administration of the hospital sector. When the 14 counties were created in 1970 their size was calculated as the population base required for running a modern hospital service. This was also the main criterion when the 14 counties were reformed into five regions in 2007 (Regeringen 2004). This again means that the regions are vulnerable if alternative institutional arrangements for the hospitals can be devised. But so far no-one has been able to do this. Although the Norwegian central government's take-over of the hospital sector was noted with interest in Denmark, no-one seems to nurture the idea of a hospital sector run by the central government in Denmark. The Finnish model – municipal cooperations – is also politically impractical in Denmark. There is a historical tradition of skepticism towards this model. There seems to be a consensus that it is too vulnerable to non-transparency and political irresponsibility. Both in 1970 and 2007 municipal amalgamations were carried through not least in order to abolish intermunicipal cooperative arrangements (Kommunallovskommissionen 1966: 167–171; Strukturkommissionen 2004: 450–461)

Based on this experience it would seem ill-advised to recommend any large-scale regionalization efforts in Finland, unless a stronger regional allegiance by the local citizenry can be demonstrated than in Denmark.

6.3 Comments on the Finnish Model: Matz Dahlberg

I have four comments on the Finnish system. The comments are related to the joint authorities, the amalgamation of municipalities, the grant system and the decentralization of services.

Joint authorities

A rather specific feature of the Finnish system is the organization of certain services within joint authorities. In the wake of the structural reform project (PARAS), launched in 2005, and the Structural Reform Act, enacted in 2006, this seems to be a growing phenomenon. A joint authority is a cooperation between two or more municipalities on the supply of some service (e.g. hospitals, basic health care, care of the disabled and vocational education). There are no elections to the joint authorities; their decision makers are chosen by the member municipalities. There are several potential problems with designs similar to those in the joint authorities: First, it is hard to know the voters' preferences for the services provided by joint authorities (the voters cannot reveal their preferences for these services through the ballot box since the elections are held at the municipal level). Second, since there is no election to these local bodies, it is not clear who the decision-maker is (difficult to know how the voters' preferences in different municipalities are aggregated within the joint authorities). Third, local accountability decreases since it becomes harder for the voters to know which decision-makers to hold responsible for the decisions made at the joint authority level (the decision-makers come from different municipalities and the decision-makers are perhaps not even the elected politicians). Fourth, the joint authorities might create common pool problems (the services provided at the joint authority level can be asymmetrically used by inhabitants in different municipalities, depending on preferences and socio-economic and demographic structure, but the costs are divided between several municipalities). One possible solution to these problems is to impose an additional local body, like the Swedish counties, that is horizontally lined together with the municipalities under the central government, which are responsible for services that need a large population base and whose decision-makers are elected in general elections.

Related to the issue of joint authorities is the recent argument that has been raised in Finland that land use planning should be moved from the municipal level to an intermediate level. If the intermediate level is not governed by a political body that has been elected in general elections, this may generate the same type of problems as discussed above for joint authorities. Apart from the political argument, it is hard to say what the optimal jurisdictional size should be for land use planning. There is always the trade-off between benefits from larger jurisdictional units (like economies of scale and the possibility to internalize externalities) and costs from them (e.g., more difficult to have good knowledge about local preferences and local conditions and decreased local accountability).

Amalgamation of municipalities

There is a recent trend towards larger municipalities in Finland, a policy that is still high up on the political agenda. This is clear from the structural reform project, PARAS, and the Structural Reform Act, but also from the fact that the central government rewards municipalities that merge sometimes between the year 2008 and the year 2013 with extra grants (the grant was 1.8-fold if the merge took place in 2008 or 2009, and 1.4-fold if it took place in 2010 or 2011). There is however potential problems associated with amalgamation of municipalities into larger units. Given the number and size of the municipalities in Finland, it is unclear from existing research whether further amalgamation of municipalities leads to significant economic improvements. Research do however indicate that local democracy worsen with the size of the municipality; the larger the municipality is, the lower is the political participation at the local level, the lower is the voters' view on the legitimacy of democracy and the larger is the differences between voters' and politicians' preferences. Research conducted on amalgamation of municipalities in Sweden also indicates that the common pool problem is to be taken seriously. Municipalities anticipating an amalgamation indulge in strategic debt behavior before the amalgam is constructed. This means that the central government in Finland through its extra grants to merging municipalities might reward inefficient, debt-financed, spending behavior. At the very least, the government financially punishes those municipalities that had merged before the year 2008. If the central government has decided that there is a need for fewer and larger municipalities, a possible solution is that the central government announces which amalgamations that is to take place and a protocol that is to be followed until the amalgamation has taken place.

Grant system

The grant system in Finland does not seem that transparent. This is a problem and calls for a grant reform. In addition, a large share of the grants allocated to the municipalities is based on municipal characteristics. This is problematic both on the ground that the municipalities can quite likely affect some of the variables through their policies, and thereby the allocation of grants, and on the ground that it is hard to know which weights to put on the municipal characteristics when deciding about the allocation rule. An important part of a grant reform could be to increase the share of general (block) grants. This would have several advantages. First, an increase in the share of general grants would make the system more transparent. Second, general grants do not affect the relative prices between different services, implying that the municipalities' priorities will mirror the costs of the municipal services. Third, general grants do not put any restrictions on municipal decision-making, which ear-marked and matching grants do. Fewer restrictions on municipal decision-making make local accountability easier. Fourth, general grants are more in accordance with the idea of local self-government than ear-marked and matching grants.

Decentralization of services

There is a large amount of tasks that are decentralized to the municipalities in Finland. A reasonable question to ask is which services are suitable to decentralize? Are all welfare services appropriate? It is not obvious that it is a good idea, for example, to decentralize primary schools and welfare. Research shows that decentralization of social welfare (welfare assistance) might lead to welfare competition among the municipalities, which in turn might lead, from a societal point of view, to a sub-optimal level in the welfare generosity (a “race to the bottom”). Research on decentralization of schools in Sweden indicate that decentralization might lead to an, from the society’s point of view, undesirable large variation over students in school resources.

6.4 Comments on the Finnish model: Lars-Erik Borge

The Finnish model of local government has the same main characteristics as the other Nordic models. The local government level is the main provider of welfare services within education, health, and social services. Total revenues amount to a substantial part of GDP and a proportional income tax is the cornerstone in the financing. A block grant system has been in place since 1993, with the purpose of equalizing service provision throughout the country. On the other hand, the Finnish model differs from the other Nordic models in two important and related aspects. It has no middle tier and relies on extensive cooperation among municipalities.

In this comment on the Finnish model I will concentrate on (i) municipal structure and municipal cooperation, (ii) the middle tier, and (iii) tax financing and tax equalization.

Municipal structure and municipal cooperation

In terms of municipal structure Finland is facing the same challenge as Norway. Many municipalities are considered to be too small to achieve efficiency and quality in service provision. In addition, both countries have relied on voluntary mergers instead of a national reform. Turning to the outcomes, Finland has clearly been more successful than Norway in terms of reducing the number of municipalities. Since 2005 the number of municipalities is reduced by 90 in Finland, compared to only 5 in Norway.

Why has Finland succeeded, while Norway has not? Both countries have applied economic incentives to stimulate mergers, but I think the Finnish design has been more effective by limiting the merger grant to the period 2008-2013 and by making the grant more generous for mergers early in the period. In addition a merger grant may in general be less effective in Norway where most small municipalities have above average fiscal capacity – the carrot becomes less tempting when they already are well off.

In the Norwegian context I have expressed skepticism towards the principle of voluntarity, arguing that it is unlikely to result in a coherent reform in all parts of the country. In some parts of the country small municipalities will merge, in others they will not. Then there is no national solution with respect to the organization of welfare services. However, in Finland the lack of a coherent reform is less of a problem given the tradition of extensive municipal cooperation. Areas where small municipalities do not merge must simply rely on cooperation.

However, I must admit that the extensive reliance on municipal cooperation in Finland is a bit of a puzzle to a Norwegian observer. Extensive cooperation makes the system less transparent and may create unclear responsibilities and little accountability. That joint municipal authorities run hospitals is particularly puzzling. Specialized medical care is a large, growing, and increasingly complicated activity where most countries are struggling with organization and financing to control costs. Municipal cooperation is seldom an alternative that is considered. Still the Finnish system seems to produce pretty good results. Is that because or despite municipal cooperation?

The middle tier

All Nordic countries are discussing reforms of the middle tier. Finland and Norway seem to be the two countries that are discussing the most drastic changes. In Finland there is a discussion to establish a middle tier, and in Norway a move to a two-tier system is on the agenda. For both countries the experience of the other are obviously of relevance.

I think the main message from the Norwegian experience is that it difficult to build up sufficient political legitimacy for a new middle tier. The establishment of the county level as a separate political level in 1976 was expected to strengthen local democracy, but the counties were never able to live up to these expectations. The citizens are far more attached to municipal and national politicians than to county politicians. And after the central government took over the responsibility for the hospitals, the county level became even weaker and more marginalized. For Finland I will argue against establishment of a middle tier of the present Norwegian type, i.e. county governments with own tax base, directly elected councils and with responsibility for regional planning, transportation, and other minor issues. Responsibility for hospitals must be a precondition for establishment of a middle tier with own tax base and directly elected councils.

The main message from the Finnish experience is that decentralized provision of welfare services and no middle tier require extensive municipal cooperation, in particular when there are many small municipalities. When a move to two-tier system is considered in Norway, it is important to think through how municipal cooperation will work.

Equalization grants

The Finnish equalization system consists of costs equalization and revenue equalization. There are three cost equalization grants related to health and welfare services, education, and general grant (capturing rural and urban cost factors). For health and welfare services and education a formula defines a calculatory cost per capita for each municipality. The per capita grant received equals the calculatory cost in excess of 65 percent of the country average. The cost equalization scheme could be revised in two ways. First, since the cost equalization grants are block grants (non-earmarked), it may be confusing to have sector specific cost equalization grants. The formulas should be merged into a single formula producing a single cost equalization grants. Second, the cost equalization could be made self-financing by letting contributions from municipalities with below average calculatory costs finance the transfers to municipalities with above average calculatory costs. The amount of money in the present cost equalization grants could be transferred into a flat per capita grant. The legitimacy of the cost equalization should be improved by publishing the analyses that have generated the formulas.

The revenue (or tax) equalization scheme guarantees all municipalities nearly 92 percent of average per capita (calculatory) tax revenue. This implies that municipalities with tax base below 92 percent of the average have weak incentives to develop the local tax base. A successful development policy has little impact on municipal revenues since higher tax revenues are counteracted by a reduction in the revenue equalization grant. To improve incentives the compensation rate should be below 100 percent also for the municipalities with tax base below 92 percent of the average.

6.5 Comments on the Finnish model: Anwar Shah

Globalization and the information age calls for empowered local governments that can work as catalysts for national economic growth and international competitiveness while advancing local economic development. The information age has also resulted in diminished economic relevance of intermediate order governments while they still retain strong political clout. China adopted such a model and local governments there played a critical role in China's success story in rapid economic growth. Local governments in most industrial countries are constrained to play such a role due to their narrowly defined range of responsibilities with even more limited own financing possibilities. There are only few exceptions and these are found mostly in Nordic countries especially in Finland. Finland should receive plaudits for several important features of its local governance. Finland gives some recognition to the role of local governments as the primary agent of people and almost all of local service responsibilities are entrusted to them. Local governments in Finland have seized upon this opportunity by innovating in diverse financing and delivery arrangements for local public services. Consistent with the analytical view, Finland has also recognized that intermediate order governments have little economic relevance unless they are constituted as consultative or cooperative bodies of local governments to deal with inter-municipal services and affairs as done in Finland. Finland also needs to be congratulated for separating the executive and legislative functions at the local government in the interest for better economic governance through appointments of professional municipal managers. Other industrialized countries can learn from this experience especially given the fiscal sustainability concerns arising from recent fiscal and financial crisis. Finland also affords its local government significant access to central revenue bases through piggybacking. Finland's system of inter-local revenue equalization is also commendable for the use of "Robin-Hood" approach for the fiscal equalization component. The structure of central-local transfers for education, health and social welfare is also laudable for their transparency, simplicity and objectivity. The missing element in design is results based accountability without undermining local autonomy through the use of output-based fiscal transfers for merit goods that set national minimum standards in education, health, social welfare and infrastructure. Finland, however, must avoid the temptations of falling in the academic trap of looking for precise justice through complex grant formulae for expenditure needs (costs) equalization as done in Australia, Netherlands and several other countries. For local fiscal discipline, Finland primarily relies on market discipline. This works only so long as rating agencies are not conflicted with personal interest and local politics is constrained by strong fiscal conservatisms by citizen-voters. For transparency and accountability, Finland requires external auditing and in budgeting has taken some steps to introducing performance budgeting. It could do more by linking this budgeting with planning and evaluation and human resource management as well as using it for benchmarking performance in local service delivery. In conclusion, Finland is already in-step with the needs of modern local governance. It simply needs to sustain the current path by fine tuning the existing system of local governance. Other industrialized countries in Southern Europe and North America and also Australia are in need of major reform of local governance and could learn from Finland's experience.

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