19. august 2013

The changing role of local income taxation in Denmark.

Jorgen lotz, Jens Blom-Hansen og Søren Hartmann Hede[1]

1. Abstract.

The theme paper for the present workshop[2] asks the question: What are the driving forces for the local tax structure. Is tax policy determining the local expenditure portfolio, or is the relationship the other way around? Is there a role played by a local desire for more municipal activity, and is it likely that the access to free rate setting for local income taxes[3] has played a role?

Historical data are not available for a quantitative analysis of this question in Denmark. The paper instead begins with exploring briefly the early historical development in Danish local finances.

The paper ventures the conclusion that the early growth in local government is caused by the central government delegation of functions to the local level. This was financed partly with grants. The grants contributed to the financing and to equalize the very uneven revenue potentials between the municipalities. At the same time local income taxes increased as the grants assumed local co-financing. But the early income tax was of limited potential.

At the beginning of the late decades of the 20th century the municipalities[4] were equipped with the responsibility for the delivery of services seen as essential for the households in education and social policy, with large, vocal and organized demanding groups of employees and users, and with unlimited access to levy modern income taxes.

This cocktail resulted in a growth in tax rates – from 15 in 1970 to now 26[5] – and growing relative size of the local government sector. It seems unlikely that the growth in the local sector had been so strong if the municipalities had only the property tax for financing it, local expenditure pressures got with the in-

[1] Marius Ibsen has made valuable contributions to the text.

[2] The Copenhagen Workshop 2013.

[3] Emphasis is in this paper on the buoyant and growing local income tax. Denmark has, like all other countries, local property taxes, but they yield only 10 pct. of total local tax revenues and their revenue growth has been modest compared to that of income tax revenues.

[4] The treatment of both subjects is on the municipal sector only. The counties have played an secondary role in these respects and are not discussed.

[5] About 4 per cent points of the increase was the result of the 2007 reforms.

come tax ample fuel supply. The local expenditure pressure became a systemic part of the system, stronger than delegations from the central government.

The growing local expenditure and tax rates drew over the years increasing central government attention to the macroeconomic consequences of local budget policies. And there was a beginning distrust in local accountability.

During the 60ies and 70ies local borrowing was gradually forbidden to reign in local investments. And in 1980 a system of annual negotiations between government and the municipal association tried to limit the growth in current spending. But the agreement system did not deliver and a policy of ad hoc sanctions was introduced beginning in the 1980ies and has since developed into legislation of permanent sanctions.

Sanctions have frozen municipal tax rates at historical levels resulting in systematic inequalities. This leaves Denmark with problems without any obvious solution. The paper discusses some options for the future development.

2. The early history (to mid-20th century).

Taxes, a brief survey of the early history[6].

In connection with the big reforms of social policy in 1803 (see appendix) a *local income tax* was introduced. It was based on local assessments of personal capacity to pay tax. The local revenue need was distributed among the citizens in relation to their estimated individual tax capacity. Property values were taken into account for these assessments. These assessments were, in particular in the rural municipalities, not handled satisfactory, and the resulting injustices were probably accepted only because of the low tax rates[7].

But already in 1861 Copenhagen got a formal local tax on income and assets, the city being too big for people to know each other well enough for a discretionary assessment. Over the years the cities also introduced rule based assessments. The tax rate was limited to 3 per cent and was until 1880 even lower.

Also in the rural municipalities the system of local assessments became over the years more and more bound by rules, but elements of estimation were in part maintained until the 1960ies.

---

[6] For the historical developments of local income taxation and company taxation see Birch Sørensen (1988).

[7] Ingvartsen (1991) pg12

The modern central government income tax was introduced in 1903. The 1903 legislation defined the basic principles for the measure of income and assets which are largely still in use. It was decided that the local authorities should use the income as defined by the central income tax law as a starting point for the assessments, but the local income tax was still a feeble source of revenue.

For Copenhagen the maximum rate was reduced to 2½ pct. but Sørensen (1988) describes how growing expenditure in 1910 led to the replacement of the maximum rate with a progressive local income tax for the metropolitan municipalities, the size of it – but not the degree of progression - was free for the municipalities to decide.

Also in the rest of the country there was a certain progression element because the municipalities could increase the taxable income discretionary for high income earners before applying the flat income tax rate. The progressivity remained until the introduction of PAYE taxation in 1969 when the proportional tax we know today was introduced.

The 1903 legislation introduced a tax both to the municipality of residence and to that of business, and of revenue-sharing with the municipality of summer residence. Already before that there had for many years been a tax on business, collected from the municipality where the income was earned without regard to where the taxpayers lived. The rules for allocation of the revenues were complicated and served two purposes, one was equalization between poor and more wealthy municipalities, the other was to serve accountability by attempting to allocate the revenue to the municipality that was responsible for the services received by families and by business (including the municipal costs of fired workers. (Vedel-Petersen. 1952)).

These business taxes were removed in 1956 when other equalization mechanisms were in place to take care of these aspects. The tax for municipalities of summer residence was abandoned in 1979.

A local *company tax* was also introduced in 1903 to supplement the local personal income tax. The idea was to get revenue for the municipalities where production took place, as an equalizing mechanism. The tax was levied at the same rate as the local individual income tax but could not exceed a rate of 5 per cent. When the local income tax rates during the 1950ies exceeded the 5 per cent ceiling the company tax became a uniform tax of 5 per cent, which in 1960 was replaced with a tax sharing arrangement. The latest development has been that, because of equalization concerns, only half of the local company tax revenue is now shared with the municipality of origin while the other half is allocated to other municipalities according to a measure of needs.

Expenditure delegation and grants, a brief early history[8].

The roots of the division into municipalities in Denmark are the parishes formed in the 11th and 12th century. Their small size was determined by the distance for the inhabitants to go to church. After the Lutheran reformation many parishes were amalgamated two or three together.

Until 1849 Denmark was ruled by absolute monarchs. However, given the technology of the time many decisions had to be made locally. There were three categories of local officials: Professional administrators (prefects), land-owners, and the clerical hierarchy, first of all the vicars. Agrarian reforms in the last decades of the 19th century turned peasants (who were tenants) into farmers owning their own land, which again necessitated a reform of the local administration.

The delegation of competences to the local level began in the early 19th century and are described in the appendix. It paints a picture of delegation of new competences for roads, social assistance and schools partly financed by matching grants covering a share of the local expenditure.

This development has been described (Philip.1954) as follows: "the state has taken over more of the legislative power and financing" and "the state has withdrawn one task after another from the local government and taken them over." Philips described the development as an agent system placing important functions at the local level in ways so the centre maintained the right of regulation and inspection of the local services.

This resulted in a growing expenditure pressure. To support the financial burden and to address the unequal financial capabilities of the municipalities the government financing was in the form of matching grants. But the grants only financed part of the local costs, they were unfunded new competences. It resulted in sizeable differences in tax rates. The development is not well documented, but in 1936/37 a family with two children and a taxable income of 2.200 kr. paid 36-62 kr. in a cheap municipality, and 153-201 kr. in a high-tax municipalitiy (Ingrid Henriksen.2000 pg. 253).

[8] The main source for this section is Betænkning nr. 471: Statens refusioner of kommunernes udgifter. København 1968

The use of unfunded new local competences stopped – like in most European countries – in the last part of the 20th century. The full compensation has been institutionalized with the annual negotiations between the central government and the local government associations. In these negotiations agreement is reached on the local spending to be expected for the following year. The expected tax revenue with unchanged local tax rates is then calculated, and the missing local revenue - the residual - determines the size of the "neutral" general grant for the coming year.

Conclusions on early history, why did local government become so large in Denmark?

The historical explanation for the large local sector seems to be that the centre (i.e. the national population) wanted bigger government. But the centre realized, as described by Philips, that it was administratively best to let the municipalities deliver the services - though keeping central control functions.

Some kind of equalization has always been needed because some municipalities were too poor to finance the desired standards. Some equalization was attempted, as said, by using matching grants (until the 1980ies). On the taxation side it was the idea with part of the local personal income tax being paid to the municipality of work, and of location of summer residence.

So towards the end of the first half of the 20th century Denmark was left with a system where grants were used, both for financial and equalization purposes, but where local taxation was beginning to be regarded as important from the point of view of responsibility[9]. In addition local governments had access to borrowing for investment purposes.

But, as local governments grew in relative importance in the national economy, the centre increasingly came to question the "responsibility" of local governments in decisions on both taxation and borrowing.

[9] Philip wrote in 1954 (pg.32): "The body which has the responsibility for a piece of public expenditure [ ] must also be responsible for collecting the necessary money from the citizens. This idea of responsibility has presumably been so obvious that it has hardly been referred to in the literature on the subject."

3. The recent macroeconomic concerns.

The recent role of the local income tax[10].

The situation at the beginning of the 1970ies was much different from the conditions for the historical framework described above. The decade opened with a large-scale municipal reform where the previous more than 1,300 small municipalities were amalgamated into 277 new large municipalities.

The national political agenda focused on the expansion of the welfare state, and this was to be a local government phenomenon. The new municipalities were entrusted with the responsibility for the delivery of services seen as essential for the households in education, old age care and child care services. In the coming decades these functions were expanded and drove up public spending.

Expansion of the local welfare was desired by the central government. However, the push for expansion also came from within the municipalities where large, vocal and organized demanding groups of employees emerged. Municipal employees developed into a group with vested interests in municipal service. This development is illustrated in Table 1.

The political influence of municipal employees and their organizations was further strengthened by the fact that their interests often coincided with those of the users of their services.

Table 1. Growth in number of municipal politicians and employees.

	1966	1990	2010
No. of local politicians	10,005	4,677	2,468
No. of local employees	46,020	451,916	527,755
No. of local employees per local politician	4.6	96.6	213.8

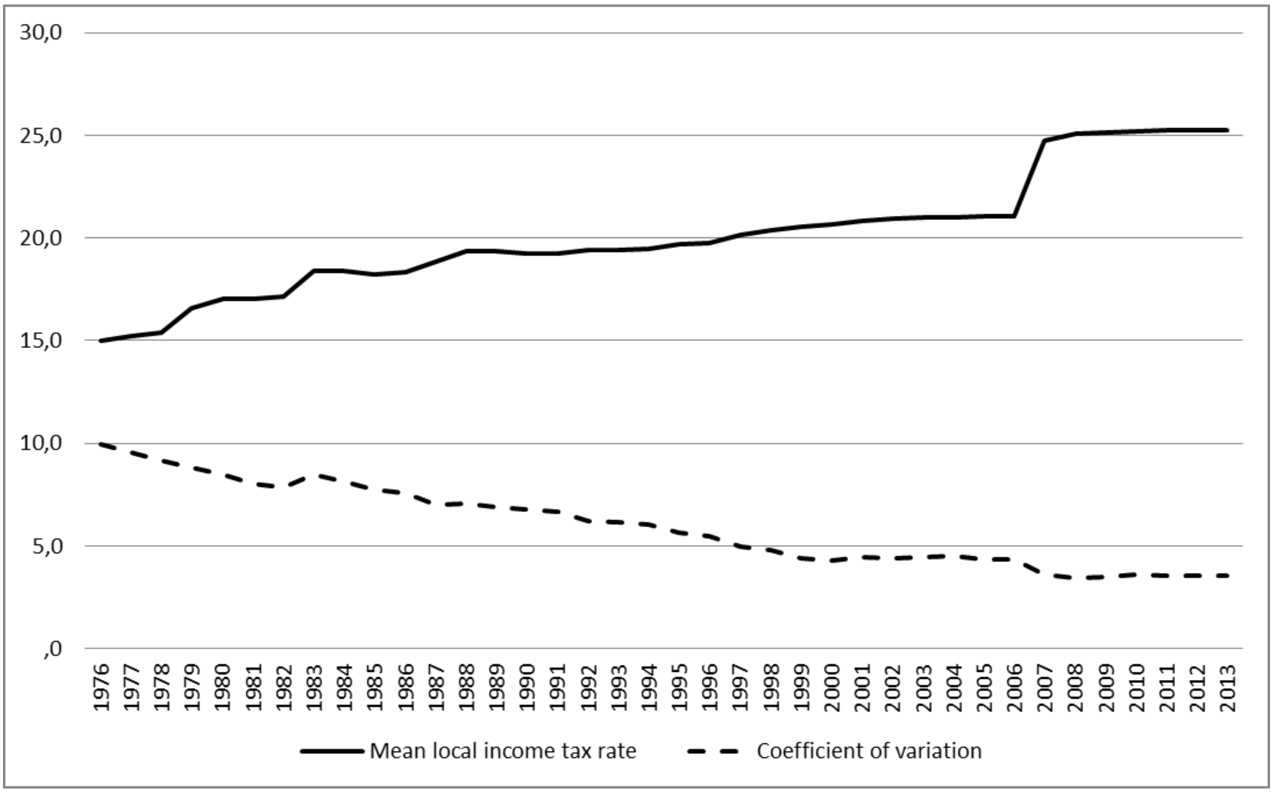
Source: Blom-Hansen et al. 2012.

And with unlimited access to set the rates for the modern rules-based local personal income tax this became a dangerous cocktail that resulted in a growing relative size of the local government sector.

Although the central government tried to keep local taxation at unchanged levels since the 1970s, local taxes steadily increased (see figure 1).

[10] Dette afsnit bygger bl. a. på Lotz (1991)

Figure 1. The local income tax rate, 1976-2013[11]



Source: Statistics Denmark.

The upper curve in the figure shows that local tax rates have steadily and incrementally increased during the 1970ies and 1980ies. From the 1990ies the rate of increase declined[12], and after the 2007 amalgamation reform the local tax rates have been almost constant due to a new system of sanctions for tax increases, cf. the description of this system below.

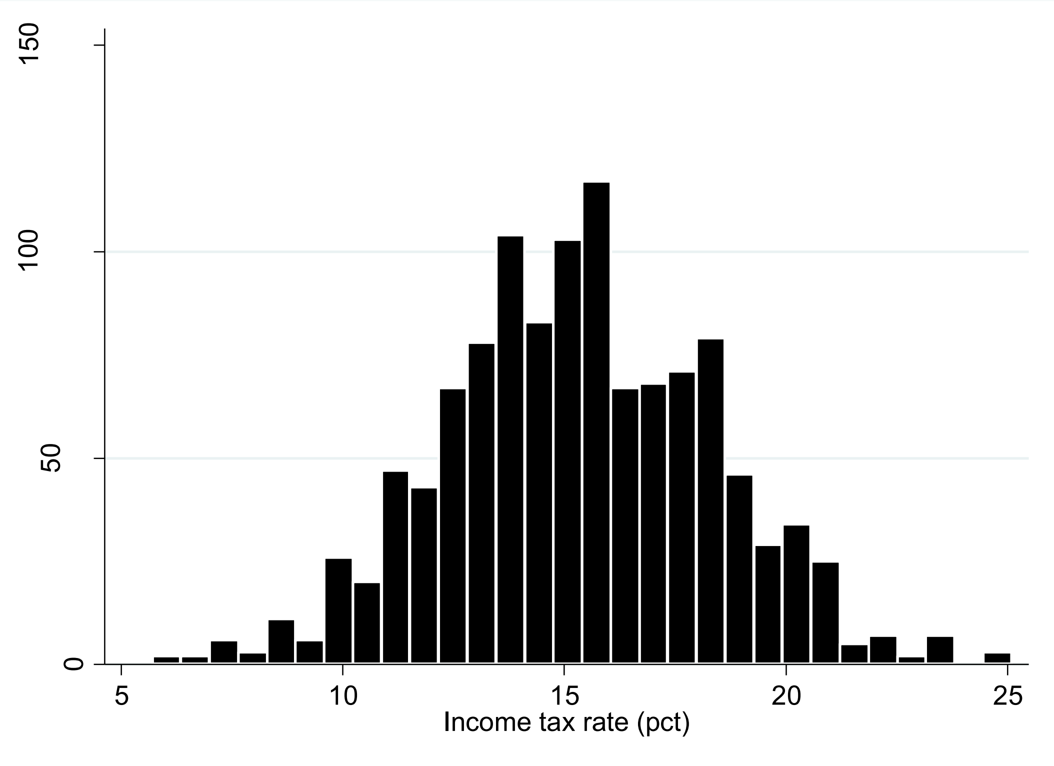
The lower curve in figure 1 shows another remarkable trait, namely that the spread around the mean local tax rate (measured as the coefficient of variation) becomes smaller over time. This means that inter-municipal differences in taxation slowly disappear. This trend had been underway already before the municipal reform in 1970. Figure 2 shows a snapshot of local income taxation in the tax year 1965-66. It includes all 1,168 ordinary rural municipalities. The

[11] Until 2007 the figure includes 266 municipalities, i.e. all municipalities except the five municipalities on Bornholm and the two municipalities on Ærø, which were amalgamated before 2007. After 2007 the figure includes all 98 new municipalities.

[12] In 2007, when a new local government reform amalgamated the 271 municipalities into 98 new large ones. This reform transferred a number of welfare tasks to the municipalities from the counties and abolished the county taxes. The previous regional income tax was divided between the central government and the municipalities which were allowed to increase their income tax rate by approx. four percentage points.

mean income tax rate was 15.3 per cent but, as the figure shows, the spread around the mean was considerable. The coefficient of variation was 19.9, almost twice as high as in 1976, the first year in Figure 1.

Figure 2. The income tax rates in ordinary rural municipalities in 1965-1966.

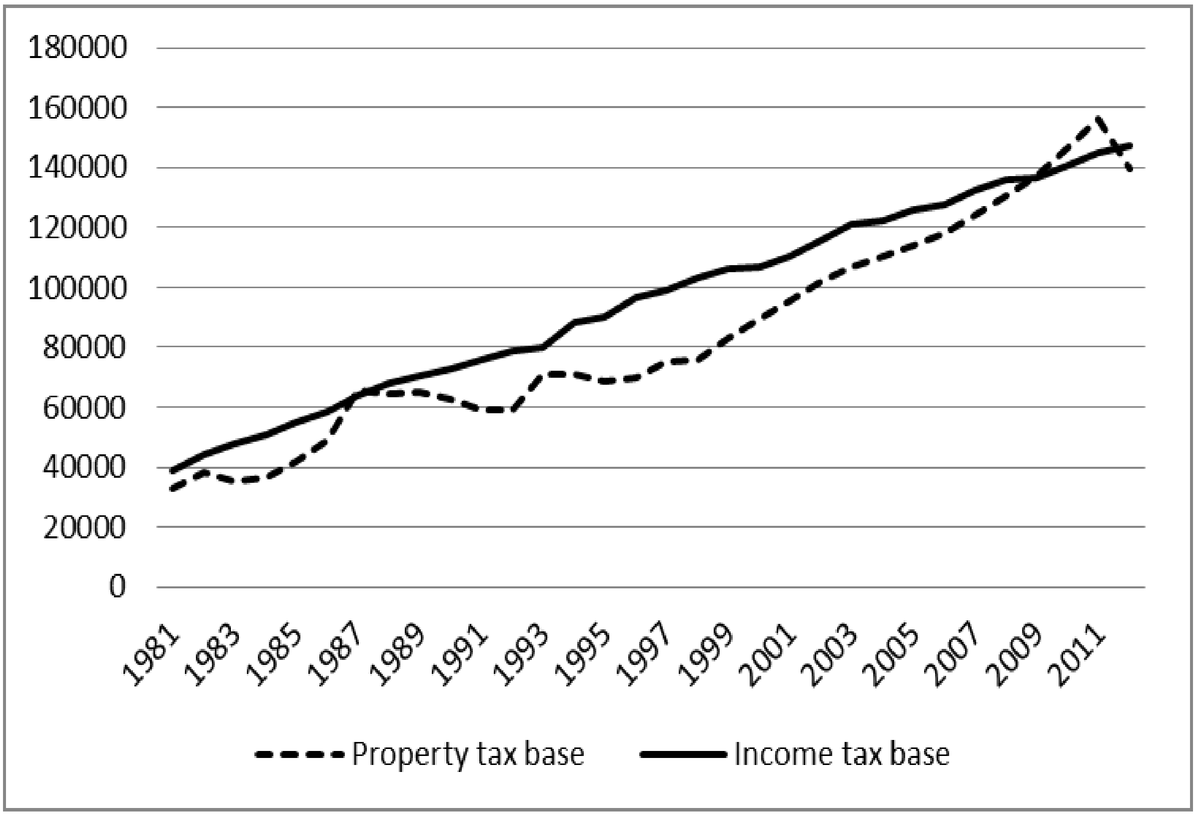


Source: Statistics Denmark

And it was no longer new functions that drove up taxes. Instead the push for more spending came as a systematic feature of willingness to spend rather than to make savings and fire staff.

The unlimited access to the local income tax was part of the explanation. It seems unlikely that this growth in spending and taxation would have taken place if the local finances had been limited to property taxes. The personal income tax provided the municipalities with a stable tax base that automatically increased in tandem with private incomes. Figure 3 confirms that the income tax base has developed in a much more stable pattern than the property tax base suggesting that reliance on property taxes would have reduced the capacity to raise more revenue. Add to this the global dislike of property taxation, very few countries raise more than 3 pct. of GDP from that source.

Figure 3. Municipal income and property tax bases, 1981-2012 (DKK per capita, current prices).

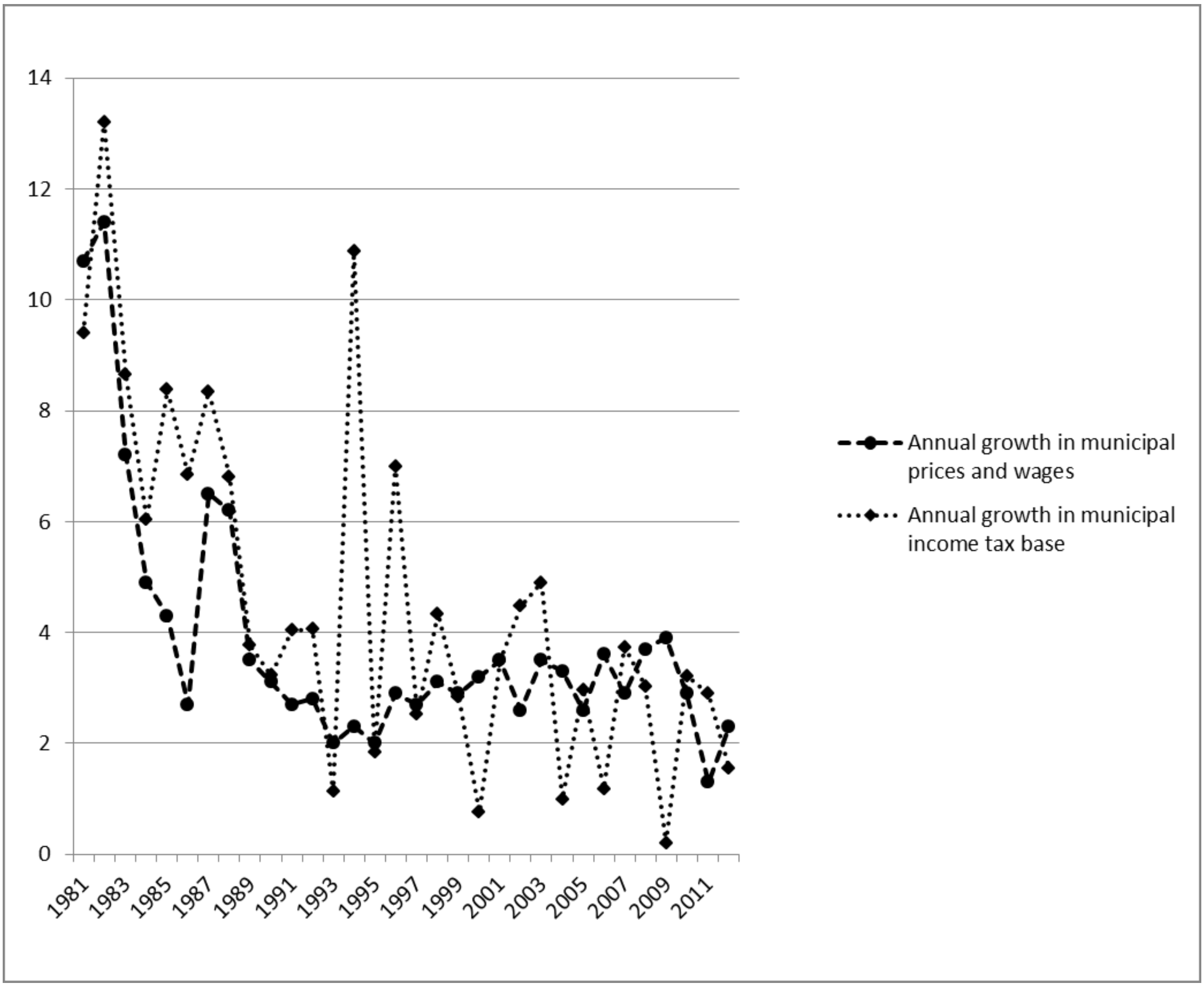


Another feature is that the municipal income tax base in most years since 1980 has increased at a faster rate than municipal prices and wages[13], especially in the beginning of the period (fig. 4). This probably allowed the municipalities to profit from a certain degree of fiscal illusion among the citizens - and thus less efficient voter control of taxation - since tax revenue increased without raising tax rates (cf. Oates 1975).

All this tends to support the hypotheses that the free access to the buoyant personal income tax played an important role explaining the late development.

[13] In Denmark local expenditure are deflated with an index combining local wage increases and the increases in the price of local purchases. In other countries deflation normally takes into account only price increases.

Figure 4. Annual increase in municipal income tax base per capita and municipal prices and wages, 1981-2012 (annual percentage increase).



Source: Statistics Denmark and Ministry of Interior.

The increases in the local income tax rates increasingly frustrated central government. The local development was against the macroeconomic policies of the central government. A lack of trust in local accountability began to develop: Perhaps too many local councils tended to find it less painful to raise taxes than to hold back service improvements and to fire employees?

The concern was first expressed in restrictions on borrowing, and later in efforts to control the increases in local expenditure and tax rates.

Borrowing restrictions.

Already in the 1950ies and 60ies the government attempted to control the local government sector growth with a number of regulations of local investment activity, mostly in the form of quantitative regulation of local construction. Nearly every year following the mid-60ies saw new regulations focused on local borrowing, and during the 1970ies this led to annual negotiations resulting in the stepwise elimination of the municipal rights to borrow. Local borrowing for investments in tax-financed functions has in principle been prohibited in Denmark since 1980.

Control of current spending.

In 1979 agreement was reached between the centre and the local governments that better control was needed, not only of investments as before but control over the overall municipal economy and taxation. The focus changed from concern of overheating the economy and wage-pressures to concern of the effects of the increasing tax rates. The result has been annual agreements between the two levels since then.

As already said, the agreements were about the size of the general grant for the following year. And in return for the right to reach agreement on the grants the municipal association agreed to "recommend" to their members to stay within overall agreed ceilings for spending and taxation. The system of agreements seemed to be a perfect construction; the individual municipalities were free to make budget decisions reflecting their own situation, but the municipal sector as a whole would respect central government objectives. This came over time to imply that the local government association (KL) replaced the central government in the role of control of the performance of the local government sector.

However, the system of agreements featured a number of paradoxes from the outset.

First, at the heart of the system is a collective action problem. The agreement covers all municipalities, but is not formally binding at the level of the individual municipalities. There is thus an incentive for the individual municipality to increase taxation and expenditure and hope that other municipalities do the opposite so that the agreement is kept at the collective level. This is where the KL over time came to play a coordinating role.

Second, when the agreement is broken, it is difficult to identify the real culprits to blame and sanction. Since the agreement is collective, the culprit is not necessarily the hard-pressed municipality which increases taxation but may well be the well-to-do municipality that did not lower taxation.

Third, the agreements' collective nature may lead to perverse incentives in a temporal perspective. There is a disincentive to lower taxation and expenditure at time t, even if the local economy allows it. Given the collective nature of the agreements, a municipality that lowers taxation or expenditure may be punished at time t+x because it may then be caught at the lower level, if sanctions for tax or expenditure increases should be introduced.

Finally, the agreements contain clear signals from the government about appropriate local government behavior. Given the hierarchical element in central-local government relations, municipalities may pay close attention to these signals. This again may introduce a homogenizing effect of the agreements. This may be part of the explanation of the continuing disappearance of inter-municipal differences discussed above in relation with Figure 1. Since the agreements were introduced as a mean to uphold local autonomy while introducing central control this may be considered a paradoxical effect.

Introduction of sanctions.

The agreements were the first few years respected by the municipalities, but already for 1983 they were broken and taxes and spending was budgeted to increase over the agreed levels.

The government responded to the 1983 budgets with cuts in the general grants forcing the municipalities to reopen their budgets to find savings. Such sanctions were introduced again for 1985 and 1986. In 1986 there was a new development in that some of the sanctions were made individual. Since 1986 the sanction policy has followed these two methods, individual and collective cuts in the general grants. The individual model ignores that the agreements did not *ex ante* oblige any individual municipality. But *ex post* the municipalities objected anyway to be penalized with collective sanctions when they individually with great effort locally had "respected the agreement".

During the 1990ies local spending increased on average by 2 per cent annually against government objective of an average of 1 per cent. Blom-Hansen et al. (2012) concludes on the 1990ies that the decade contributed to the conviction of the central government that the system of agreements was not effective enough.

Permanent sanctions, the freeze of local tax rates.

In 2009 the government consequently introduced a new sanction regime different from the past. Firstly, the new system is permanent. The sanctions are known in advance when the municipalities prepare their budgets. Secondly, the new system has a heavy weight of individual sanctions (see box) making the sanctions directly operational for the individual municipalities, but maintaining the collective idea of the negotiation system.

Present system of sanctions (2013-14).

The present system of permanent conditional sanctions on the *taxation side* are as follows, on condition that the overall tax recommendation is broken: The first year 75 percent of the extra revenue from the tax increase is clawed back from the individual municipality, for the two following years it is 50 per cent, year four 25 per cent. The rest of the revenue from the tax increase is deducted from the general grants (collective sanctions). After year four the whole amount is clawed back as a cut in the general grants.

On the *expenditure side* the government reserves part of the general grant for the coming year as conditional grants to be released only if the over-all municipal current spending respects the agreed level both in the municipal budgets and in their closed accounts.

The new kind of sanctions increased the inflexibility in the local tax policy already noted for some time. Fewer and fewer municipalities dared to reduce their tax rates fearing that they would not be allowed to increase taxes again later should the need arise. Some municipalities probably also feared demonstrating affluence in times when equalization reforms are constantly on the menu and several grants are becoming more discretional.

Some figures illustrates the problem (Lotz.2007): During the period 1985-91 the average number of municipalities which reduced their tax rates was 80, during the period 2000-06 the average number of tax reductions was 8.

As fewer municipalities dared to reduce taxes, and the average level had to remain unchanged, few municipalities could be allowed to raise their tax rates. This has resulted in doubts as to the real freedom of local authorities to determine their own tax rates.

The government has in different ways tried to “unlock” the freeze in local taxation. Since 2008 it has allowed annual local sanction-free tax increases of a certain amount (financed by cuts in the general grants). The permission[14] needed to increase tax rates is given on application by the Ministry of Interior. Tax increases exceeding the allowed amount are subject to sanctions. The annual rounds of applications for permissions to tax increases has amounted to much more than there was reserved for the purpose, a sign that tax increases are not by all municipalities seen as undesirable.

In a further attempt to loosen up for more flexibility in local tax policies the government for 2013 and 2014 introduced, in addition to the pool for sanction-free tax increases of maximum 250 mill. kr., a premium for tax rate reductions symmetrical to the sanctions on tax increases. The subsidy was for 2013 – but not 2014 – reserved for municipalities with tax rates above average. 11 municipalities reduced their tax rates for 2013 reducing the revenue with 191 mill. kr., the preceding years 2010-12 there were tax rate reductions in on average 3-4 municipalities, so the incentive seems to have had an effect. The results of the 2014 subsidy remains to be seen.

Inequalities frozen with the local tax rates.

The sanctions for tax increases are now permanent and there is no convincing policy aimed at recreating more flexible local rates. This has resulted in a situation that does not seem sustainable. The freezing of local tax rates at historical levels creates tensions, and "it is doubtful whether this state of affairs is sustainable in the long run" (Blom-Hansen.2010).

Among other things the municipal reform of 2007 and the simultaneous tightening up of the equalization system together with different demographic and social developments have resulted in historical tax rates that does not reflect the present needs.

[14] The permissions do not depend on whether the tax rate is high or low, it depends on the municipality being able to convince the Ministry that they find it difficult to finance their desired spending, thus adding to a soft budget constraint already present in the allocation of discretionary grants.

Table 2: Tax rates, service levels and income for high- and low-tax municipalities (2011)

Income tax rates 2011 (2x10 out of 98 munici-palities).	Average tax rate, pct.	Average service level*	Average taxa-ble income, kr.
Top ten in tax rates.	26,8	103	146.000
Bottom ten in tax rates	23,4	98	211.000

* "Service level" is spending divided with expenditure needs, 100 is average service, more than 100 is high service level (or low cost efficiency).

There are some systematic features in the type of municipalities that are left with low tax rates vs. those with high tax rates (table 2). It seems that the low tax municipalities tend to have high average income compared to those ending up with high tax rates. The reasons for this are not clear.

The table demonstrates a close correlation between tax rates and service levels. The low tax municipalities have lower service levels than those municipalities who have inherited a high tax rate. It also shows that the low tax/low service municipalities are mostly found among the high income municipalities.

One hypotheses could be that the rich municipalities historically have had low tax rates, perhaps enough in earlier times to finance good service, but reforms and the tightening up of the equalization system have reduced their service to below average, much lower than the high tax (and poorer) municipalities.

But the picture is probably more muddled since the definition of service levels also includes substantial local expenditures for income transfers and social services, which tend to be higher in poorer municipalities compared to rich municipalities. Without complete equalization this would tend to result in high service/high tax levels in poor municipalities and low service/low tax levels in rich municipalities.

It should also be noted that the rich municipalities have not been first in line to apply for permission to tax increases, which indicate that they do not have strong need for higher taxes. Furthermore, the low tax municipalities have quite comfortable liquidity reserves.

This calls for further investigation into the causes behind tax-levels in Danish municipalities. But the overall conclusion is still the same: Tax levels of Danish municipalities are frozen at historical (and arbitrary) levels, and this will cause tensions in the long run since municipalities cannot adapt to different developments in local conditions.

What are the options for the government to do something about it?

The government has, as said, for the time being not been especially active to defrost the frozen tax rates. And it is difficult to see what could be done.

If the government decided simply to give up sanctions it would probably result in substantial tax increases, while only few municipalities would – at least in the beginning - dare to reduce their tax rates. And such a development would not be in accordance with the policy of reducing the income tax rates.

To avoid this a deregulation could be supplemented with systems of more visibility of the local tax rates. This could be done letting the national PAYE system of withholding, which now differs for individuals according to their municipality of residence, withhold instead at an average municipal rate, and to let local deviations from the average be settled between each municipality and its tax payers. This idea has been aired by academics but it has found no political support. Another academic proposal has been to introduce trade-able permits to tax increase to be sold by municipalities who are prepared to lower their taxes for a price. The political problems with this is the smell of "market mechanism", and the fear that the result would be seen as poor municipalities selling tax reductions so that rich municipalities can buy tax increases.

The "Norwegian perspective"

This leaves the option to pave the way for giving up the local freedom to set their own tax rates by introducing a ceiling for local tax rates to be lowered year by year until the differences in local tax rates has been squeezed out. The local income tax then would become a tax sharing system without local influence on the tax rates, like the systems existing in Norway and Iceland. This may initially result in better cost efficiency. One problem with such a "Norwegian" solution is that there are still a number of responsible municipalities who see tax increases as undesirable. This effect, where it may be found, will be lost. And this responsibility has for many years politically been the main pillar for the local financial system, it is a big step to give it up.

Another problem with a "Norwegian" model may be that the Danish Parliament has signed the Council of Europe "Charter of Local Self-Government". This

Charter states in article 9 par.3 that "part at least of financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate". If the local income tax is replaced with a tax sharing arrangements, the local tax freedom will be only in the property tax.

There are two problems with that. One is whether the Charter would be satisfied with that (probably yes, if the rate variation of the property tax is not limited too much by law). The other is political. Danish tax policy has over the years had the implicit goal to make property taxes less visible, it is a question whether Parliament will take responsibility for giving the very visible local property taxes a dynamic role in the tax policy arena? And note, the central government property tax has for the same reason been cleverly integrated into the PAYE income tax collection.

Can Denmark re-create free local taxation like in Sweden?

Recreating free local taxation, what we may call the "Swedish" solution, would require renewed fiscal responsibility from the municipalities in Denmark. In Sweden municipalities seem to have less appetite for higher expenditure and higher taxes when compared to Denmark. Can anything be learned from a comparison between the two systems, the Swedish and Danish?

In Sweden municipalities are less protected by the state via block grants in times of economic recession. This means that there is no automatic lifesaver from the central government if for example revenue from income taxes drops due to an economic downturn. Each municipality has to rely on its own ability to uphold sound economic finances. This may explain a higher degree of fiscal responsibility in Swedish municipalities compared to Denmark.

It may require rather drastic changes in order to return to a system of municipal responsibility in Denmark. Inspired by Sweden one such change could be that municipalities in Denmark became less protected against economic downturns (and upswings). This could include reducing the block grant and abandoning of the annual automatic adjustment of the block grant that under the present system serves to balance total expenditure and total financing.

Abandoning the automatic adjustment of the block grant would be challenging for the Danish municipalities due to the many functions and responsibilities that they have. Especially the economic responsibility for almost all income transfers in Denmark would put hard pressure on municipalities in case of an economic downturn. Therefore it would probably be usefull to reconsider the many functions and responsibilities of Danish municipalities if the automatic adjustment of the block grant were abandoned. This would go against the recent policies where the Danish municipalities have been given responsibilities for almost all income transfers.

The problem with the solution is that these drastic changes come with no guarantee for success. Municipalities without a safety-net (and with fewer responsibilities) would probably be more fiscally responsible – but the risk is there that they might instead use their freedom to raise taxes and expenditure.

All in all, the options are not appealing, and the tensions built into the present system may for some years remain unresolved. Considering firstly the slow process of local tax-reforms in the past, secondly the ingrained dictum that competence and responsibility should be placed at the same level, and thirdly the politically entrenched role of the annual negotiation system it should not be expected that the frozen system of local income taxation – obviously undesirable as it may seem – will be changed in any significant way soon. Neither the local side nor the government have so far voiced support for any solution.

Appendix. The early history of delegation of functions to the local level and grants financing.

Roads. In order to implement maintenance of the main road system a central government subsidy was awarded in 1793. The argument was interestingly that there were externalities (Bet.451). Roads not only benefitted the local populations but also the populations of the neighboring municipalities. From 1910 this subsidy was replaced by a share of the new motor vehicle duties. The central government share was earmarked for a road fund, and the local share for road expenditure was in the 1930ies 50-60 pct.

Social affairs. In 1803 a significant new legislation introduced administrative reform in the countryside. The vicar was still the central figure, but he was to be assisted by a few farmers who were not elected but appointed, and who to a large extent represented taxpayer interests rather than the interest of the poor. The new legislation also defined the poor relief service and its financing. This legislation transferred for the first time a small part of the legislative power from the local to the central government. The ability to tax-finance better services differed, however, very much between municipalities, and subsidies were introduced to enable also the poor authorities to deliver. In 1891 a 50 pct. refund was offered for local spending on care for the old, during the 1930ies this was increased to 60 pct.

Schools. From 1806-14 schools – like poor relief – were to be governed by a commission of local, non-electe, worthies headed by the vicar. There were big differences in the financial power of the school funds (each covering several municipalities), and in 1857 the first subsidy from the centre was introduced to assist financing the wages and pensions for teachers. This system of financing was expanded and improved following the increasing central regulation. The central share of local spending on schools was in the 1930ies 35-40 pct. growing to 85 pct. when the reforms of the 1980ies replaced the conditional grants with general objective grants.

Equalization. During the following years up to the 1950ies the equalization aspect became clearer with the establishment of equalization funds, first financed by the municipalities. Later - from 1937 - the fund was given own revenue from income and property taxes. Local spending increased during the following years to satisfy new central demands, and in order to finance this coverage from the equalization funds was increased. By the end of the 1950ies school subsidies amounted to more that 80 per cent of local spending and more that 70 per cent for social spending.

Literature:

Blom-Hansen, Jens (2010): Local government in Denmark. In Antti Moisio (ed) Local Public Sector in Transition. Government Institute for Economic research. Helsinki.

Blom-Hansen, Jens, Martin Bækgaard and Søren Serritzlew (2013): Do tax limitations work? In the proceedings of the 2011 Copenhagen workshop.

Blom-Hansen, Jens, Marius Ibsen, Thorkild Juul og Poul Erik Mouritzen (eds) (2012) Fra sogn til velfærdsproducent. Syddansk Universitetsforlag.

Christiansen, Peter Munk and Michael Baggesen Klitgaard (2010). "Behind the veil of vagueness: Success and failure in institutional reforms" Journal of Public Policy 30: 183-200.

Council of Europe (1986) European Charter of Local Self-Government. European Treaty Series – No.122. Strasbourg.

Henriksen, Ingrid (2000) Finansforvaltningen i Dansk ForvaltningshistorieII, Jurist og Økonomforbundets Forlag.

Ingvartsen, Oluf and Palle Mikkelsen (1991):Kommunalreformen i Danmark 6. Forlaget Kommuneinformation.

Kommuner og kommunestyre (1966). Betænkning nr. 420.

Lotz, Jørgen (1991) Økonomiske aftaler mellem stat og kommuner. Kommunal Årbog. Forslev & Co. København.

Lotz, Jørgen (2007) Spillet om kommunernes økonomi. In Lundtorp, Svend and Rasmussen (ed) Rigtigt kommunalt. Handelshøjskolens forlag.

Oates, Wallace E. 1975. ”Automatic increases in tax revenues – the effect on the size of the public budget”, in Wallace E. Oates (ed.). Financing the New Federalism: Revenue Sharing, Conditional Grants and Taxation. Baltimore: John Hopkins University Press.

Philip, Kjeld (1965): Skattepolitik. Gyldendal Copenhagen.

Philip, Kjeld (1954): Intergovernmental Fiscal Relations. Ejnar Munksgaard, Copenhagen.

Statens refusioner af kommunernes udgifter. 1968. Betænkning 471.

Sørensen, Peter Birch (1988): Den kommunale indkomstbeskatning i Danmark. Bet. Nr. 1134. Copenhagen.

Vedel-Petersen, K. (1952): Danmarks Statistik. Gads Forlag, Copenhagen.