

Specific and general grants in Sweden – what has occurred after the grant reform in the 1990's?

Local government in Sweden form a significant part of the economy. By international standards, a relatively large share of the welfare services are provided by local governments. In 2008 local government expenditures accounted for 23 % of GDP and 25 % of employment in the economy. Local government is divided into two functional levels with overlapping geographical jurisdictions, municipalities and county councils.

Local governments cannot define tax bases on their own, but they have the right to set their own tax rates. The average tax rate for local governments was 31,44 % in 2008 (on personal income). To alleviate the financial burden and to equalise for differences in income and costs, the central government allocates grants to local governments.

There are two types of local governments; municipalities and county councils. Municipalities are responsible for a wider set of functions¹, such as running schools, social services and taking care of the elderly whereas the county councils provide general and specialized health care. Parliament sets goals for different services instilled by special laws whereby local governments have been mandated the running of different services. Deregulation and decentralisation are defining concepts for these special laws. The same could be said for the local government grant system that was put in place in the early 1990's.

The foundations of the present grant system for local governments were laid down in 1993 by means of a reform intended to improve the efficiency of local governments and in a wider sense dampen the public sector's rate of expansion. Although some features have been modified or replaced during the way, the basic principles of the grant system that was put in place then remains unaltered. The ambition of this study is to describe what has transpired since the grant reform took place, with emphasis on the last five years.

The objective of this paper is to examine whether a shift has taken place with respect to the use of general and specific purpose grants allocated to local governments in Sweden.

The questions posed in this study are:

- Have the specific purpose grants increased?
- How has the balance (policy-mix) between general and specific purpose grants evolved over time?

Intergovernmental grants

What is a specific purpose grant?

Theoretically, a grant intended for a specific purpose alters the price of a particular service to the recipient local government and depending how the grant it is designed it evokes both an effect on the income and the mix of services². In this study, a specific purpose grant is a transfer from the central government to the local governments aimed at a specific function or

¹ See appendix 1 for a more detailed description.

² Werner Z. Hirsch, Working paper no 622, University of California, p. 7, 1991

activity and intended for consumption³. General grants are also intended for consumption but by definition they do not fund a specific purpose or activity⁴ (see below). In effect, there are no restrictions on the spending of the general grants.

In this study, the term grant refers to budget items on the central government budget bill that contain fiscal transfers to local governments. In this setting, a troubling point is that a budget item may in fact carry more than one conditional grant, meaning that the fit between budget items and specific grants is not a perfect one. This makes it hard to correctly assess the number of specific purpose grants at certain points in time. The Swedish Agency for Public Management (Statskontoret) has published a number of studies where the term refers to a definition structured by budget items. The same definition is applied in this paper. Unless specifically stated, grant equals budget item.

What is a general grant?

Theoretically a general grant increases the income of the recipient and therefore only brings about an income effect⁵. A number of changes in the grant systems for local governments have occurred over the last 15 years. These changes have also altered the terminology by which general grants are denoted in Sweden. In this study, the various systems of non-conditional government grants for local governments that have existed are denoted as general grants.

General grants meet the following two criteria:

- Grants are allocated with “no strings attached”, in the sense that the funds can be spent in the manner that the local government see fit for itself.
- Grants are allocated within a common, non-voluntary regulatory system that is ultimately controlled by the central government.

General grants in Sweden 1993-2008

In 1993 the government introduced a new grant system for transfers to the municipalities⁶. This system replaced the previous system where the bulk of transfers to local governments were made up of grants for specific purposes. The new grant system for the municipalities relied on three components: equalisation of income, equalisation of costs and a supplement for municipalities with a large population decrease⁷. A few municipalities with a very high did not receive the new grant. In the case of county councils, only small changes were made in 1993. In 1996 a similar grant/equalisation system was imposed on the local counties.

In 1996 another change was made to the general grants. Unlike previous system, all municipalities and county councils were now made part of the system. Equalisation was now also neutral in terms of government finances, as both income and cost equalisation were financed by the local governments⁸ through a subsystem of grants and fees. This equalisation

³ Budget items that are classified as transfers intended for investments are excluded from the analysis.

⁴ Statskontoret, Verksamhetsanknutna statsbidrag till kommuner och landsting, p. 20

⁵ Werner Z. Hirsch, Working paper no 622, University of California, p. 7, 1991

⁶ Prop. 1993/94:100, Bilaga 1, s. 64

⁷ Local government financial equalisation, Ministry of Finance Sweden, 2008, p. 31

⁸ Local government financial equalisation, Ministry of Finance, 2008, p. 31

system was in force until 2005, when the income and cost equalisation systems once again were altered, implying changes in the general grant system.

See appendix 2 for a more detailed description of the general grants.

The grant reform of the 1990's

Arguments in favour and against conditional grants

At the time of the reform, the central government stated that the system based on conditional grants possessed a number of weaknesses that called the system into question. The conditional grants were obstacles in achieving greater flexibility and hindered coordination at the local level and tied down administrative resources⁹ that could be put to better use. Also, the need for a general grant system was reinforced by the financial crisis that called for a more efficient provision of public services.

Specific grants had been invented for a number of purposes, namely to provide financial support, to equalise differences in taxing capacity and costs and to stimulate the expansion and provision of certain public services¹⁰. The system relied on the assumption that conditional grants could contribute towards equalising service levels and secure an element of basic security and fairness to citizens, irrespective of their place of living. These features had played an important part in expanding the scope of the public sector.

The grant reform hinged on the concept that grants distributed to local governments for activities for which they are responsible should be dismantled and instead put into a coordinated general grant system. The size of a grant to a specific municipality was made independent of the actual activities undertaken by that municipality, and instead made a function of the perceived structural needs of the municipality (both in terms of income and costs). In order to finance the new general grant for the municipalities, 18 specific purpose grants were abolished in 1993. From a financial standpoint, these grants represented the bulk of the funds.

Another pillar of the grant reform was achieving a more transparent division of responsibilities between the state and the local governments. According to the proposal made by the central government, the state should take responsibility for the totality of public services and the economy as well as for securing that the needs of the citizens are ultimately catered for. Due to these reasons, the state should be able to line out the economic scope of local governments.

The motives behind the grant system reform were to equalise the financial conditions for local governments, enhance local flexibility, to transfer power for shaping services according to local needs and promoting economic efficiency. The state should limit its role and generally refrain from regulating in detail and instead focus on steering and supervision by means of nationally established objectives and goals. By mandating local governments a higher degree of freedom with respect to organisation and capabilities¹¹, the new Local Government Act that was put in place in 1992 took local governments further down this path.

⁹ Prop. 1991/92:150, del 2, s. 44

¹⁰ Prop. 1991/92:150, del 2, s. 43

¹¹ Prop. 1993/94:100, Bilaga 1, s. 66

Criteria for specific grants that should remain

In conjunction with the reform in 1993, 46 grants with a specific purpose were not abolished. Exception was made for grants that were allocated to local governments according to the following criteria:

- were payments for services undertaken on behalf of the state,
- intended for investment and development,
- existed due to labour market considerations,
- for public housing,
- were paid on equal terms to local governments and other organisations and
- for renewal and development projects.

The impact of the grant reform in the 1990's

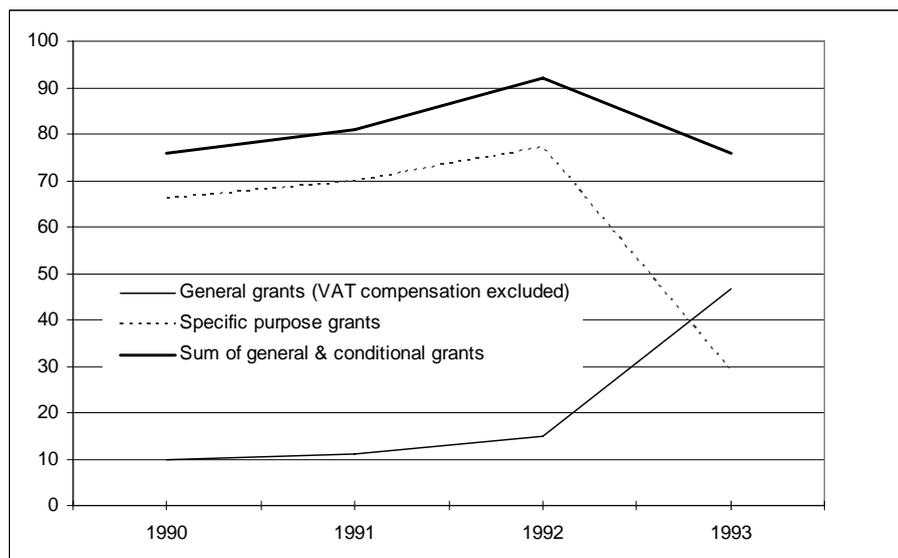
Between 1990 and 1992 the sum of transfers to local governments increased by 16 billion SEK (+21 %), mainly due to an increase of specific purpose grants. Diagram 1 illustrates the impact of the recomposed grant system. In 1990 the payments from specific purpose grants were roughly six times larger than from the equalisation grant¹² (classified as a general grant).

Transfers from the specific purpose grants increased up until 1992 and then faded sharply in 1993 when the new general grant system was introduced and the general grant overtook the specific purpose grants in size. The central government budget was running yearly deficits and the ratio of public debts to GDP was growing taller by the year. As a measure, the government proposed a cut back on the new general grant to local governments. Following the government's announced structural programme¹³, the sum of transfers to the local governments fell by roughly 7,5 billion SEK between 1992 and 1993. Also, as a part of the grant reform of 1993, various fees paid by local governments to the central government were abolished. To offset the financial impact, the general grant was reduced with equal amount. The general grants for the municipalities amounted to 39,6 billion SEK and to 7,9 billion SEK for the county councils in 1993.

¹² Here, the term general grant refers to the grant that was distributed for redistributing income to local governments with high tax rates and low tax power.

¹³ The did not specifically use this term in the relevant government bill, but the reality of it was of equal significance. Prop. 1991/1992:150, Del 2, p. 57

Diagram 1: General and specific purpose grants* in the early 1990's



Sources: Ds 1994:61 & Regeringens skrivelse 1994/95:220.

*Current prices, billion SEK

Specific grants as a source of income in the 1990's

Another way to study the impact of the grant reform is by relating transfers from specific purpose grants to the income of local governments. In 1990 transfers from specific purpose grants¹⁴ represented 18 % of local governments income. By 1992 this proportion had increased to 19 % and in 1993 it had fallen back to 7 %. The grant reform implied that local governments came to operate in a altogether new fiscal situation.

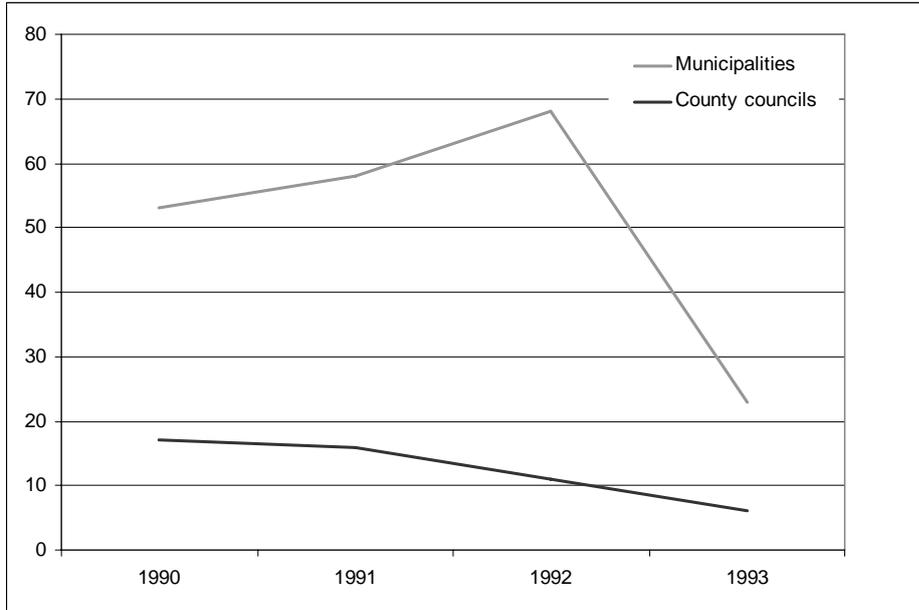
A majority of the amount of specific grants went to municipalities

As illustrated by diagram 2, in the early 1990's, a majority of the specific grants were allocated to municipalities. While the specific grants allocated to the municipalities grew between 1990-1992, the amount allocated to the county councils declined. Specific purpose grants amounted to app. 22 % of the municipalities income in the time span 1990-1992. For the county councils, income from specific purpose grants amounted to app. 10-13 % of income. Taxes were the prime source of income amounting to 70 % of income for the county councils, whereas the municipalities counted on taxes providing around 50 % of income in the early 1990's. The central government imposed a moratorium on the local governments tax rates that was in place during the same time period¹⁵.

¹⁴ This sum includes transfers from the social security system for the county councils.

¹⁵ Ds 1994:61, p. 39

Diagram 2: Specific purpose grants for municipalities and county councils 1990-1993*



Sources: Ds 1994:61 & Regeringens skrivelse 1994/95:220.

*In billions of SEK

Fewer specific purpose grants?

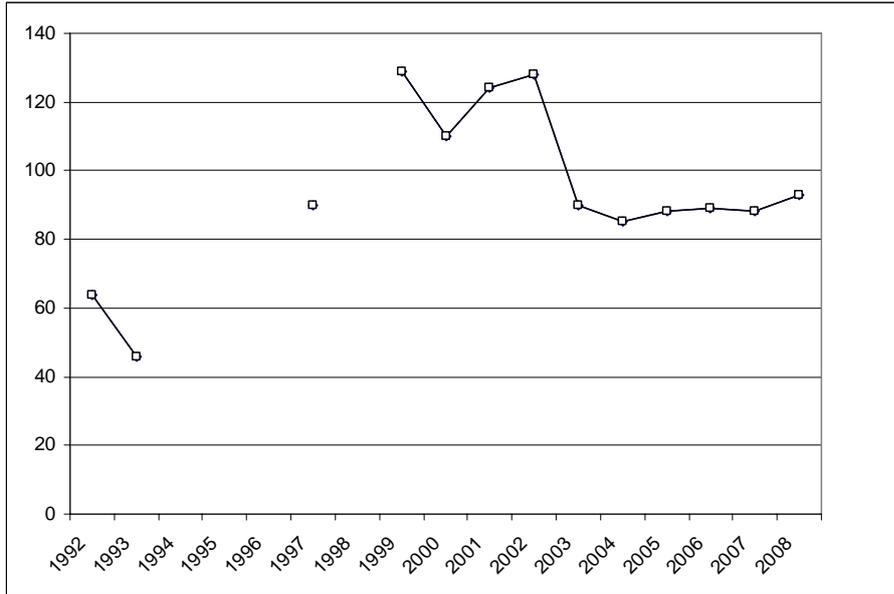
Diagram 3 illustrates the number of specific grants between 1992 and 2008. Since data for some years in the mid 90's have been hard to come by, this time series is unfortunately not complete. However, it provides an overview of the extent to which specific grants have been put to use.

In the 1990's extensive changes were made to the systems of central government grants to municipalities. The number of specific grants for local governments fell from 64 in 1992 to 46 in 1993, when the grant reform came into force¹⁶. Resources from the dismantled specific grants were reallocated to finance the new (general) equalisation grant. Following the fall in the in the number of conditional grants that occurred in 1993, by 1997 the specific grants had grown to 90. In 1999 the number of specific grants peaked at 129.

Between 2002 and 2003 the number of specific grants fell drastically and since then the number has maintained a steady level at about 90. No isolated or single factor can explain the decrease in specific grant, but some evidence suggest that the transfers to local governments were differently structured than previously and that transfers from some of the minor budget items has ceased.

¹⁶ Prop. 1991/92:150, del 2, p. 57

Diagram 3: Number of specific grants



Sources: Prop. 1991/92, del 2. Statskontoret, rapport 2003:5. Ekonomistyrningsverket, Statsbudgetens realekonomiska fördelning.

The last five years

Specific and general grants 2003-2008

Diagram 4 shows the allocation of specific purpose grants and general grants for local governments in monetary terms from 2003 through 2008. Between 2003 and 2007 the sum of grants increased by 32 billion SEK (+34 %), mainly due to an increase in the general grants following the new local government equalisation system that was set off in 2005 (see appendix 2) and that has factored in quite heavily on the policy mix between specific and general grants. Some grants for specific purposes were abolished and instead used for financing the new equalisation grant. The correlation of the size of the general grants and the specific grants is partly explained by this.

The sum of transfers from the specific purpose grants increased from 46 billion SEK in 2003 to 56 billion SEK in 2006, but has since declined and amounted to 49 billion SEK in 2008. Transfers from specific grants were greater than the general grants in 2003 and 2004, but in 2005 order shifted¹⁷.

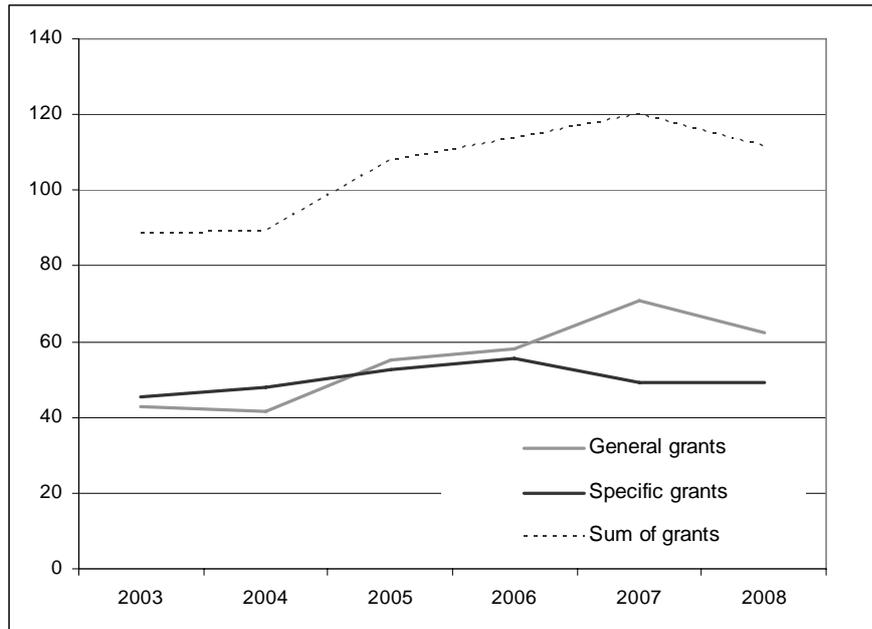
In monetary terms, 75 % of the specific grants were allocated within the areas of education, social services and health care (in 2006)¹⁸. These areas form the nucleus of local governments¹⁹.

¹⁷ In addition, local governments have benefited from tax deductions. These deductions are not classified as expenditure in the government budget bill, nor in the national accounts. In 2002 the tax deductions amounted to 5 billion SEK. The peak came in 2005 when they amounted to 13 billion SEK. Since then they have faded in relevance, partly because a large part of these deductions were moved into the general grant in 2007.

¹⁸ Own calculation based on data from Ekonomistyrningsverket.

¹⁹ See appendix 1 for a description of the responsibilities of municipalities and county councils.

Diagram 4: Specific and general grants



* Current prices, billion SEK

Source: (2000-2008) Ministry of Finance.

There are other measures that have had impact on the size of the general grants.

In 2007 some tax deductions that local governments had benefited from were moved from the income side to the expenditure side of the central government budget, in effect increasing the general grant by app. 7 billion SEK.

The definition of general grants implies that the central government does not exercise any special condition in the allocation or the use of the grant. But the general grants also work as a conduit for managing the impact of economic policy that has fiscal implications for local governments. Changes in economic policy and legislation with such an impact can occur in a range of fields, such as the size of tax base, pension rights or the delegation of functions to local governments. If the central government delegates functions to local government, it is by principle obliged to offset the imposed financial burden by increasing the size of the general grants. Widening the base for raising taxes or user fees may be offset by withdrawing funds from the general grants.

In 2008 the general grant for the municipalities was reduced by 12 billion SEK in order to neutralise the financial impact of a real estate tax reform²⁰, which induced a decline in the total sum of transfers to local governments.

A majority of the amount of specific grants are allocated to county councils

Diagram 5 illustrates the allocation of specific grants for municipalities and county councils between 2003 and 2008. A majority of the specific grants are allocated to county councils, though one should bear in mind that there is one single specific grant that accounts for nearly 30 % of the transfers from specific grants to local governments. Since 1998 the county councils have had formal responsibility for paying pharmaceutical benefits. The central

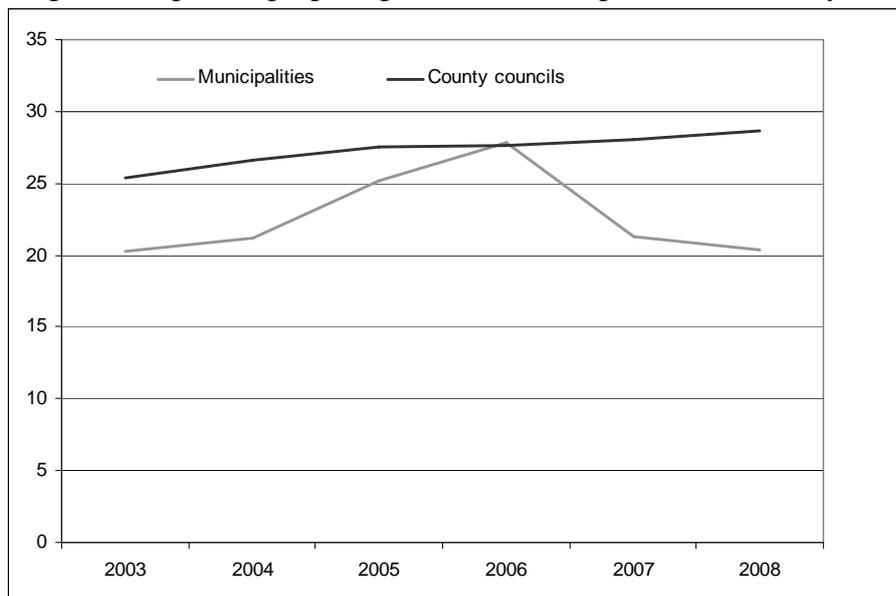
²⁰ Whereby the municipalities were allowed to raise fees on real estate that corresponds to the previous state tax on.

government finances the main part of these costs by means of a specific grant that in 2008 amounted to 21,6 billion SEK²¹.

Fore mentioned pharmaceuticals grant accounts for nearly 75 % of the conditional grants for county councils. The costs for pharmaceuticals has increased over the period and by the same token, the grant has expanded.

The specific grants for the municipalities increased by 7 billion SEK between 2003 and 2006 and then fell back by the same amount in 2007 and 2008. The number of specific grants have been more or less constant during this period. Neither the increase or the decrease of transfers from the specific grants correlate with variations in the number of specific grants.

Diagram 5: Specific purpose grants for municipalities and county councils 2003-2008



Source: Ministry of Finance

Note: In billions of SEK. Figures do not include tax deductions.

Specific and general grants as a source of income

Earlier in this paper data stated that the proportion of local governments income provided by the specific grants fell from 17 % in 1992 to 7 % in 1993. Diagram 7 illustrates central government grants as a proportion of local government income between 2003 and 2008.

Between 2003 and 2006 specific grants accounted for roughly 8 % of income for local governments. This proportion dropped to 7 % in 2007 and 2008²². Meanwhile, the general grants grew in significance. In 2003 general grants accounted for 7 % of local government's income. By 2007 this proportion had grown to 10 %.

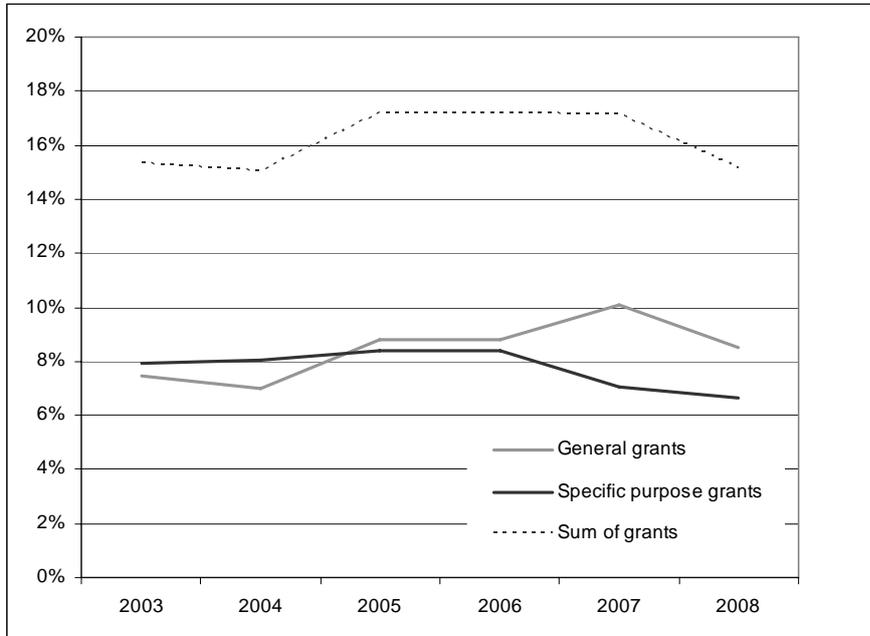
As suggested by diagram 5, the majority of the specific purpose grants are allocated to county councils. Between 2003 and 2008 transfers from specific purpose grants accounted for app. 13 % of the income of county councils and roughly 5 % of the municipalities income.

²¹ Local government financial equalisation, Ministry of Finance, 2008, p. 30

²² By extending the horizon back to 1998, 7 % corresponds to the median value.

The curve representing the sum of all grants as a share of local government income shifts upwards in 2005 (diagram 6), but then declines in the subsequent three years, even though the grants grew in monetary terms during the same period. This relative decline in significance is a product of the fact that the rate of growth in tax revenue has outstripped growth in grants. In 2005 the sum of general grants, conditional grants and tax deductions accounted for 19 % of local governments' income whereas in 2008 they represented merely 15 %.

Diagram 6: Grants as proportion of local government income*



Source: Ministry of Finance

* Income according to the definition of the national accounts.

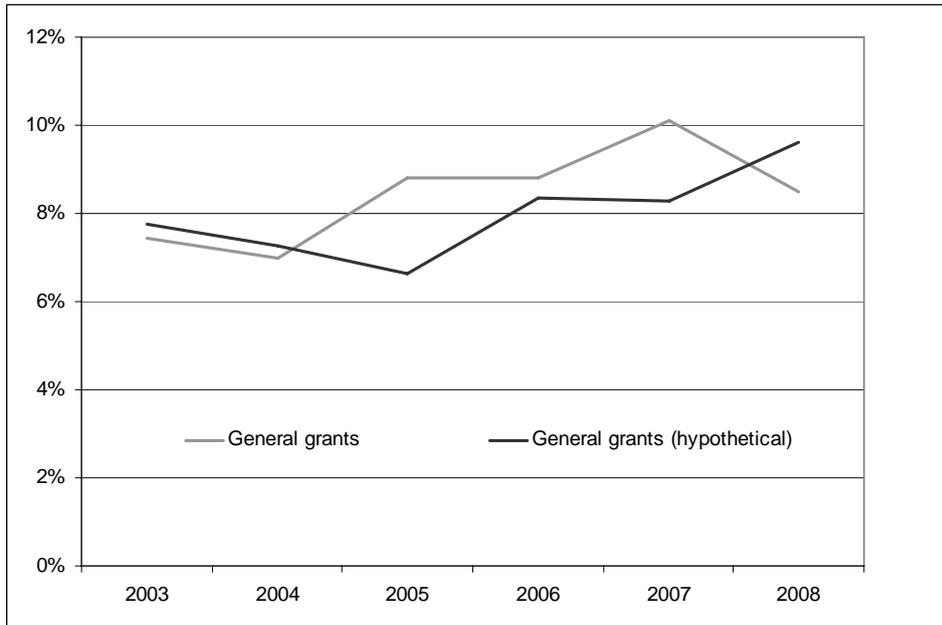
Note: Preliminary calculations for 2007 and 2008.

Economic policy has impact

By controlling for changes in the general grant due to changes in government policies and legislation with financial implications for local governments, we can derive a slightly different picture grants financial significance. For the sake of comparison with the points made in previous discussion, the curves are calculated relative to local government income. Diagram 7 contains a curve illustrating the actual payments from the general grants and another curve showing hypothetical payments.

What do we mean by a hypothetical grant curve? Let's present an example. In 2003 the size of the general grant was reduced by 34 billion SEK, nearly halving the available funds. This cut was mainly due to a change in the methodology for reimbursing local governments for the value added tax that they had taken on for the purchase of services and goods. In 2003 and 2004 the hypothetical general grants lie above the actual general grants, which implies that funds were in fact withdrawn from the local governments. In 2005, 2006 and 2007 actual general grants exceeded the hypothetical general grant, meaning that the local governments received compensation by the central government for changes in policy and legislation.

Diagram 7: Actual and hypothetical general grants



Source: Ministry of Finance and own calculations

Hypothetically speaking, had the central government e.g. not undertaken the real estate reform of 2008, transfers from the general grants would have accounted for 9,6 % of income and income from all grants 17 % instead of the actual 15 %.

Conclusions

Following the reform of the intergovernmental grant system in the early 1990's, conditional grants declined in financial significance. Instead, greater emphasis was put on the use of non-conditional, general grants.

In accordance with the stated intentions, the grant reform of the 1990's had impact on the policy mix between conditional and general grants. By consequence, funds from conditional grants fell from representing 17 % of local governments income in 1992 to 7 % in 1993. But in spite of the intentions of the grant reform, the number of conditional grants grew significantly between 1993 and 2001, partly as a response to policies adopted with the ambition of influencing the priorities of local governments. Specific grants were instrumental in achieving that.

Evaluating the past five years, transfers from specific grants increased between 2003 and 2006, but has since then fallen back slightly. Between 2003 and 2006 conditional grants accounted for 8 % of local governments income, but the proportion has fallen back to 7 % since then. Transfers from specific purpose grants have grown in size, and to a certain extent in numbers, but their significance as a source of finance has in fact declined.

Along with the decline of the specific grants, the general grants have increased in size and significance as a source of income. However, in 2008 the sum of all intergovernmental grants account for a smaller share of local government income than in the three previous years (2005, 2006, 2007). Grants from the central government accounted for 15 % of local government income in 2008.

Even though specific purpose grants have declined as a source of finance, one significant shift has taken place. In the early 1990's, municipalities relied to a greater extent than county councils on income from specific purpose grants. Following the introduction of the pharmaceutical grant which has been allocated to the local counties beginning in 1998, events are now reversed. In the last five years, specific purpose grants have grown more important for county councils than previously, whereas specific grants have declined in significance for the municipalities compared to the early 1990's.

The specific grants have different purposes, rules and target groups. Some grants are intended for all local governments. Other grants are partly intended for all local governments. A third category consists of grants where the funds were not explicitly destined for local governments, but where transfers to local governments have taken place.

Specific purpose grants destined for a *particular* group of municipalities and county councils, is the kind of grant that has increased by the highest rate between 1993 and 2001²³. According to the Swedish Agency for Public Management, that type of grant may be a source of conflicts and distortions, especially when conditional grants target local government functions and activities that indeed are covered by the cost equalisation system. This distortion poses a challenge to the equity component²⁴ of the equalisation system, mainly because specific grants that are allocated to particular local governments finance activities that the non-

²³ The Swedish Agency for Public Management (Statskontoret), rapport 2003:5, p. 78

²⁴ Intergovernmental fiscal transfers, Boadway & Shah, The World Bank, p. 15, 2007

receivers either cannot undertake or have to pay for by their own means²⁵. There is a risk that specific purpose grants contribute towards an uneven playing field where some local governments can reap benefits that others cannot realise due to financial constraints or grant rules.

²⁵ The Swedish Agency for Public Management, 2003:5, p. 9

Appendix 1

The functions of local governments in Sweden

Local government in Sweden is divided into two levels that consist of 290 municipalities and 20 county councils. Local governments have the right to levy taxes on individuals personal income²⁶ and to some extent raise user fees to finance the provision of services. The average tax rate was 31,44 % in 2008, whereof 2/3 represent taxed levied by the municipalities.

The municipalities are responsible for public services in a number of areas such as basic and secondary education, kindergartens, elderly care, social services, communications, environmental protection, fire department, public libraries, water and sewage, waste management, civilian defence, public housing and physical infrastructure. On a voluntary basis municipalities may also provide or subsidise leisure activities, sports and culture, technical assistance, energy supply, and promote tourism. To a certain extent they may promote and subsidise business development.

County councils are responsible for providing primary and specialised health care and dental care. They may also engage in promoting culture, education and tourism.

Regional and local public transport is a common responsibility for the municipalities and the county councils.

²⁶ Profits on capital, interest rates and windfall gains (eg. housing) are taxed by the state.

Appendix 2: General grants in Sweden

Table 1: General grants in Sweden

Period	Name	Components
(-1992)	Tax equalisation grant for municipalities.	Consisted of a general and an additional tax equalisation component. Subsystem of fees and grants. Equalisation of structural costs, mainly demographic and social factors. Supplement for population decreases.
(-1995)	Tax equalisation grant for county councils.	Consisted of a general and an additional tax equalisation component. Subsystem of fees and grants. Equalisation of structural costs, primarily demographic factors.
1993-1995	Equalisation grant for municipalities	Consisted of income and cost equalisation and a special supplement for municipalities with a large population decrease. A few municipalities with tax capacity above the guaranteed level fell outside the grant system.
1996-2004	General grant for municipalities and county councils	Consisted of income and cost equalisation, transitional regulations and a general government grant paid on a per capita basis, weighted by a demographic factor. Equalisation of income and costs were financially neutral since charges and grants were financed by the local governments. The system included all municipalities and county councils.
2005-,	Local government equalisation grant for municipalities and county councils	Consists of income and cost equalisation, a structural grant, a transitional grant and an adjustment grant/charge. Equalisation of costs is financially neutral since charges and grants are financed by the local governments.