

Financing the Municipalities and Counties in Norway - Specific Grants vs. Block Grants

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Foreword

In 1986 the so-called General Purpose Grant Scheme for municipalities and counties was introduced in Norway. The new block grants replaced a financing system based on several different earmarked grants, even though it already existed a tax equalisation system. In the new General Purpose Grant Scheme both the grants and the tax equalisation are parts of the same system. The intention with this reform was to ensure a transparent, fair, rational and stable distribution of income. There existed large differences between municipalities and between counties in both the level of income and in the level of expenditure needs. A high degree of redistribution was therefore necessary, and this was achieved by the new grant scheme. The high number of earmarked grants had also been an administrative burden both at the local and at the central level.

Today the main sources of revenue for municipalities and counties are taxes, block grants, specific grants, charges and fees. Their free income consists of block grants and tax revenues. The free income is still being distributed by the General Purpose Grant Scheme. The general grants are calculated on basis of objective criteria, and in addition the income taxes are equalized. The free income share of the total income of the municipalities and counties is approximately 67 percent. Some of the responsibilities of the municipalities and counties are still being financed by earmarked grants, supplied by financial contribution from the municipality itself and charges from the inhabitants. In 2008 the earmarked grants' share of the total income was approximately 13 percent. In addition, the municipalities have revenues from rates, stocks and property taxes.

Some key indicators

(See appendix for more facts about the financing of the local sector)

Composition of revenues 2004-2008, percent					
Year	2004	2005	2006	2007	2008**
Share of free income	69,3	68,3	69,1	67,6	66,8
Share of specific grants	10,2	10,5	11,7	12,6	13,0

**Estimated accounting figures for 2008

Number of earmarked grants					
2004	2005	2006	2007	2008	2009
39	41	43	43	46	48

From 2004 to 2008 the share of earmarked grants has increased, mainly because there has been a strong growth in the kindergarten grants. In 2008 the earmarked grants accounted for 13 percent of total income in the local government sector. In recent years the central government has implemented a reform of the kindergarten sector in order to achieve full kindergarten coverage. This commitment is financed by several earmarked grants, and in 2008 57 percent of the earmarked grants goes to investments in and the operation of kindergartens. The reform is now nearly completed, and in 2011 the kindergarten grants will be included in the general grant. The great commitment to kindergarten coverage can explain much of the volume growth, but also the number of relatively small earmarked grants has increased the past five years. In 2004 there were 39 different earmarked grants, today the number is 48.

Guidelines and principles

A strong public sector and a good welfare system are important and desirable goals for the Norwegian government. The local government consumption accounts for 13 percent of GDP in

continental Norway, and one in five of all employees in Norway are working in the local government sector. The municipalities are the central actors in solving the large social tasks such as education, kindergarten and health care. It is a national goal to offer citizens a high level of public services in all parts of the country. Therefore the central government has different goals to achieve when they distribute grants:

1. To ensure that the municipalities can afford to solve their tasks (income effect)
 2. To ensure an equalization of expenditure costs
 3. To reach sectoral goals; effect the priorities of local government
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1. In Norway responsibility for central welfare tasks is given to the municipalities and counties. The sector has considerable tax revenues, but this does not provide sufficient resources. Therefore the central government must supply the local sector.
 2. The distribution of responsibilities between the different levels of government in Norway is currently based on what is called the *generalist local authority system*. This means that all the municipalities are intended to fill the same functions. They all have the same responsibilities regardless of size. The revenues and the expenditures vary between the municipalities, and it is necessary to equalize both the expenditures and the taxes.
 3. Grants can be a strong and efficient means to reach sectoral goals. If there is a need to raise the level of quality of a nationally high prioritised service, grants can be a tool to effect the priorities taken by local government.

Specific grants or block grants?

If the central government has delegated responsibility for a certain task to the local sector or decided to strengthen the efforts concerning an existing task, the municipalities will get an economic compensation if the expenditures increase, in order to achieve congruence between tasks and resources. The central government can then choose to increase the free income through the General Purpose Grant Scheme or establish a new specific grant. The new task can also be financed by fees. Fees and charges are mainly used as payment for water, sewage and waste, but some services are also financed through a combination of grants and fees (for example kindergartens). However, use of fees and charges are limited means, because they can be assumed as an extra tax. The typical welfare services shall reach everyone, independent of personal income.

The choice between general grants or earmarked grants depends on several factors; consideration of local democracy and local political priorities, the needs and preferences of the inhabitants, differences in local conditions, efficiency and also cost-efficiency, macroeconomic control, equality, quality and the wanted level of activity.

An important principle in the Norwegian system is that municipalities and counties mainly should be financed by general purpose grants. The local welfare services then become subjects for local political priorities, which make the local politicians responsible for local welfare decisions, and at the same time the administrative costs both at the central and local level are at their lowest. Financing by general purpose grants also strengthen the possibility to achieve macroeconomic control.

On the other hand, specific earmarked grants can be a strong and efficient means to reach a sector goal, because the supply of resources motivates for the production of a certain task. In this case the priorities are de facto made by politicians at the national and not at the local level. Sometimes it can be a rational and reasonable decision to choose an earmarked grant. Therefore some responsibilities are financed by earmarked grants.

It does not exist definite or categorical rules for when to choose a specific grant, but some guidelines are:

- when financing goods and services with low national coverage
- when financing services only in a few districts, to reach particular groups or persons
- when financing services for a strictly limited period

-Low national coverage

Earmarked grants have been used to finance services when the national coverage has been low, and where it was of great political interest to reach a higher coverage, or to raise the quality of a service. Earmarked grants have also been used to build up new welfare services. Earmarked grants can be very efficient when the use is restricted to a few areas, or if the grants are given for only a restricted period. Through an earmarked grant economic incentives will be established, and a high coverage of the service can be achieved sooner than through a general grant. Studies have shown that this effect decrease when the coverage increase. When the coverage originally is low, a higher level can

be reached faster through a specific grant. When a certain and sufficient coverage of the service has been reached, the Norwegian policy is to include the specific grant in the general grant.

The kindergarten grant is an adequate example. The reason given for financing kindergartens by an earmarked grant was that the coverage had been too low, and for a long time it was a politically important goal to achieve full kindergarten coverage. Now the goal of full kindergarten coverage is reached, and in 2011 the grant will be included in the general grant. Another example is the grant to after-school activities (is any program which invites youth to participate outside of the traditional school day). When the program was new and the coverage was low, the service was financed by a specific grant. Now the municipalities have provided a satisfying level of the service, and the grant is included in the general grant.

- Some particular districts or groups

Some public services shall only be delivered in a few districts, to special groups of inhabitants, or the need for the service can vary considerably among the municipalities. Financing these kinds of services by a general grant is not purposeful because of the high differences in production costs. In addition, the grants may be small measured in money. The equalization of expenditure mechanism in the general grant scheme demands a certain size of the grants (or productions costs) if the criteria shall be effected. A too small amount of money will not change the existing criteria, and the preferred distribution between municipalities will not be reached. At the same time, the criteria system can not be used for services produced in only a few municipalities because then the production costs do not differ systematically. The equalization of expenditures mechanism cannot handle these tasks; one solution is to work out special mechanisms in the General Purpose Grant Scheme. On some occasions this can be done; in the scheme it is possible to distribute a specific grant for a shorter period. The grants will then be given together with the general grants, and no reporting on the use of the grants will be requested. The rule in this case is that the specific grant after a while shall be included in the general grant and distributed by the equalization of expenditures mechanism.

However, is it necessary to reach an absolutely fair distribution for all services? The Norwegian municipalities have a lot of responsibilities because they are the central element in solving large social tasks. Therefore, the sector also has large resources, the revenues in local government sector amounts nearly 18 percent of GDP in continental Norway. In spite of the many small entities, the municipalities are in general robust economic units. If the financing of a specific service is included

in the general grant without changing the existing criteria, some municipalities will gain and some will lose considering their expenditures. If a municipality gain on one area once, next time they will perhaps lose. In the long run their income will nearly be equalized. An important question is how detailed should the distribution of income necessarily be? In some cases earmarked grants are more suitable, because it is politically important to visualize the grant. On other occasions, it will not be possible to obtain an efficient allocation of resources by the general grant, because the needs are too asymmetrical combined with high demand for revenues.

An example of earmarked grants in category 2 is the grant for the settling of under age refugees. There are too few municipalities that wish to settle single under age refugees. On the other hand, settling is an expensive task and not an ordinary task for the local authorities. The efficient solution is to pay the municipalities for the service by an earmarked grant. Another example is the grant to the fishery harbours and grants for the prevention of snow slides. These grants concern only a few municipalities, but are financing important tasks that must be solved. Therefore the best solution can be to give an earmarked grant to the local authority. Without visualizing and establishing an economic incentive there is a possibility that these tasks will not be solved.

- Strictly limited period

Also grants that are supposed to exist only for a short period of time can rationally be given as an earmarked grant. Examples are grants to science and special projects.

The Norwegian policy is to limit the use of earmarked grants. Financing the local sector by general purpose grants is an important principle for most of the political parties. Specific grants are not considered suitable as the main source of income for the municipalities. If new reforms and lifts in a sector are financed by earmarked grants, the share of the income coming from general grants will be reduced. For the second, earmarked grants are normally given on the condition that the municipalities will make their own financial contribution. This will set the free income financing under pressure, because the amount of resources spent after local priorities will decline.

As discussed, specific grants can in some cases be a strong and efficient means to reach a sector goal. In the next chapter different ways of designing earmarked grants will be discussed, also new forms of earmarked grants; sector plans followed by earmarked grants and compensation for rent expenditures.

Different kinds of earmarked grants

We will not take into account grants that are pure repayment for costs, for example a service where the municipalities can send the whole bill to the central government. Earmarked grants can in principle be designed in two different ways.

- grants given after objective criteria (they do not influence the price)
- grants given after level of activity (they influence the price)

Some earmarked grants are in the same way as the general grants distributed after objective criteria, for example after the number of inhabitants in the municipality or other population characteristics. This type of grants is mostly used to achieve a higher level of activity on a certain area, for example services to the elderly or to disabled people. The municipalities shall report to the central level how they spend the money, but the grant is not given on condition of their own financial contribution.

More common are earmarked grants based on activity. For one produced unit, for example a kindergarten place, the municipality receives a grant. This type of grants normally requires a financial contribution; the municipality must pay some of the costs but the service then is cheaper to produce. These types of grants are supposed to cover expenditures, not investments.

There are also some related grants where the local authorities can get some of their expenditures covered after applying for it, or the central government cover a certain amount of the expenditures. These grants have mostly been used to support investments, not to support daily services. For example, some years ago high priority was given to build nursing homes, and the municipalities could after application get investment support through an earmarked grant. The last years the central government has also given rent support to local governments. After application they can get support to cover rent expenditures in specific investments, for example to restore churches. These types of grants have also been designed as a combination of a general, earmarked grant (given after objective criteria) and a pure specific grant. For example, every county becomes a frame for investments and the grant shall cover the rents. The total frame is distributed among the counties by objective criteria. In the next step the municipalities can apply for support until the county's frame is spent.

Discussion

Earmarked grants can be a strong means to reach a sector goal, but they have some strong disadvantages.

- chaotic
- high administrative costs
- unfair distribution
- weak control over the total amount of expenditures
- weak control over allocation
- manipulative
- efficacious ?

In Norway the municipalities have mostly the same responsibilities, even if the numbers of inhabitants vary from 200 to 600 000. General grants consider the existing variations between the municipalities. The general grants are based on objective criteria and the equalization of expenditures. The general grant is a stable source of income; when local decision-makers plan the budget for the next year the level of income from general grants is already known.

On the other hand, the local authorities must normally send an application if they want an earmarked grant. The process creates administrative burdens both at the local and at the central level. The local government must also know the rules for distribution of a specific grant, which grants are new, and the local politicians must decide whether the municipality shall apply for it or not. If a major part of their revenue is coming from earmarked grants the result can be rather chaotic. In addition, it can be difficult to know how much revenue the municipality will get for a certain task. Again, this can cause problems for the planning and carrying out of services. Earmarked grants are therefore more efficient when the use is restricted to a few areas.

If a major part of the municipalities' income is depending on specific grants, the allocation of services and goods might not correspond to the inhabitants needs. The earmarked grant is a result of the priorities made by the politicians representing the national parliament, and not at the local level. Again, the specific grants do not consider the existing variations between the municipalities. This may give as a result that municipalities with a satisfying level of quality of the service will either loose the grant or provide an over dimensioned service- neither is economical.

Specific grants are normally given on the condition of financial contribution from the municipalities and counties. If the grant shall be a strong and efficient tool to effect the local priorities, this must be an assumption. However, the amount of free income and the financial situation vary between the municipalities. Some of the differences are intended, for example the General Purpose Grant Scheme contains grants to remote areas, and other income sources can also cause unintended disparities. The result of earmarked grants is that the municipalities and counties that are financially strong, have better opportunities to release specific grants. This may increase the differences between the municipalities.

As mentioned before, some earmarked grants are given after objective criteria. The goal is to strengthen a particular task or service. This type of grant is not as efficient as grants that require a financial contribution, but studies have shown that they can have an effect on the local priorities if they are followed by massive and powerful information. However, the local level can manipulate these grants by not using their own free income to solve this specific task. A similar problem can occur with grants which requires a financial contribution. The municipality does not necessarily use more of their free income when the central government offer a specific grant to strengthen a task. The local government can choose to use the same amount of money as before and get more services, or they can choose to reduce their normal contribution and achieve the same level of the service as before. This problem has been tried solved with more reporting from the local authorities.

Conclusions

A conclusion is that earmarked grants have many weaknesses. Are they efficient tools? The answer is both yes and no. As described before, sometimes is it easier to finance a task by earmarked grants than by the general grant. If only specific areas or persons are targeted by the supply or if the coverage in a specific sector is low, earmarked grants may be efficient tools. Also if the central government shall pay for specific services provided in the municipalities, earmarked grants can be the answer.

However, the main intention with earmarked grants is to influence the local priorities. Therefore specific grants are normally given on the condition of financial contribution. The past few years we also had massive lifts in a limited period followed by earmarked grants. As described there are mechanisms that can neutralize the effect of earmarked grants, but the experience is that they work, especially if the coverage of the service is low. The mechanism is very simple; an earmarked grant makes it cheaper to produce a service and the municipalities demand the grant. The problems with

high administrative costs and uncertainty around the budget process are on the other hand more difficult to solve. The most serious problem is perhaps that the central politicians effects the local priorities by using earmarked grants. The result can be that the local politicians are waiting for the next earmarked grant, the next «lift», instead of putting their own choices in to action. Financing municipalities and counties by general purpose grants makes the local welfare services subjects for local political priorities. In general, block grants give the municipalities and counties a better opportunity to adjust the welfare services to local needs and demands.

Among national politicians and also among the ministries the standpoints vary. The sector politicians often want to give their own responsibilities a lift, and often want to use earmarked grants to reach a sector goal. Others are more concerned of reaching efficiency in the long run, and having macroeconomic control with the budgets. It is not possible to predict to what degree the local level will use an earmarked grant, and the bill can be higher than calculated in the budget. To what degree the local sector is financed by earmarked grants is a result of the political process.

From a professional point of view, earmarked grants must be handled with care, only a smaller part of the municipalities' income should come from earmarked grants. The specific grants are efficient when the use is restricted to a few areas. In Norway today there is a balance between general and earmarked grants. The past years the share of earmarked grants has increased mainly because of the strong growth in the kindergartens grants. The rest of the earmarked grants are rather small.

One challenge is to continue the dialogue between the state and the local sector to achieve changes in the municipalities' welfare services without comprehensive use of laws and rules and earmarked grants. There are ongoing contact between the central government and The Norwegian Association of Local and Regional Authorities (KS). These consultations provide a forum for discussing the framework for distribution of revenues in relation to the tasks carried out by the local government, the financial situation of local government and efficiency means. These consultations can be the first step to achieve agreement on necessary efforts.

Appendix

	2004	2005	2006	2007	2008**
Total revenues*	214066	228933	252016	266993	287931
Free income	148307	156319	174202	180355	192203
Earmarked grants	21840	24030	29420	33681	37389
Share of free income	69,3 %	68,3 %	69,1 %	67,6 %	66,8 %
Share of earmarked grants	10,2 %	10,5 %	11,7 %	12,6 %	13,0 %

Table 1:

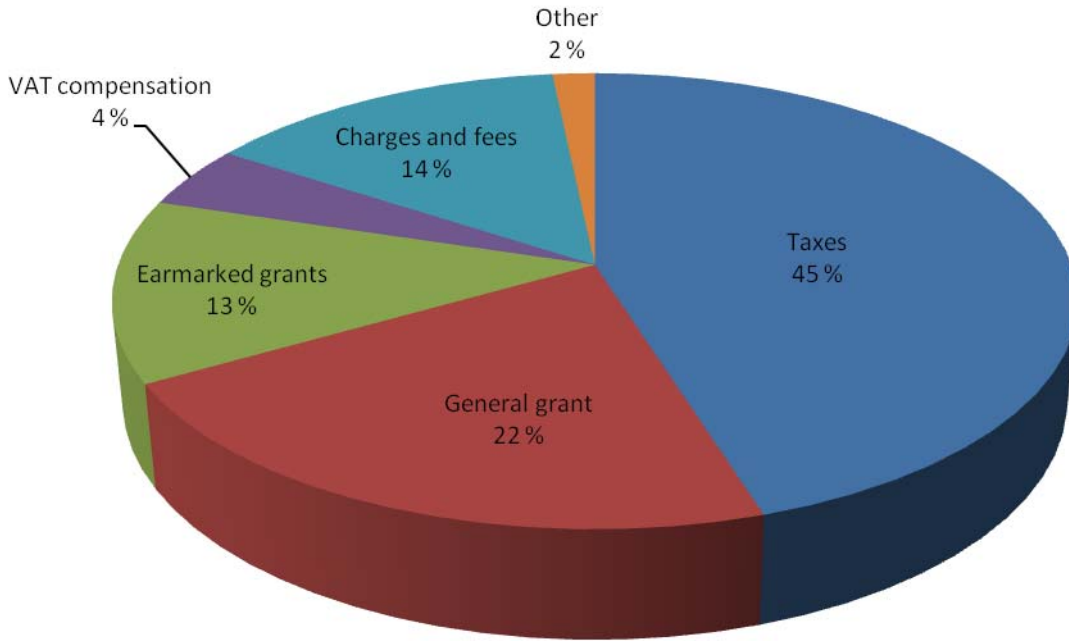
Composition of revenues in the local government sector 2004-2008. Share of free income and earmarked grants. Accounting figures measured in millions (NOK) and in nominal prices.

**Accounting estimates for 2008

	2004	2005	2006	2007	2008	2009
	39	41	43	43	46	48
Growth 2004-2009:		23,1 %				

Table 2:

Number of earmarked grants 2004-2009. Budget numbers for the respective years.



Figur

e 1: Composition of revenues in the local government sector. Accounting estimates for 2008.

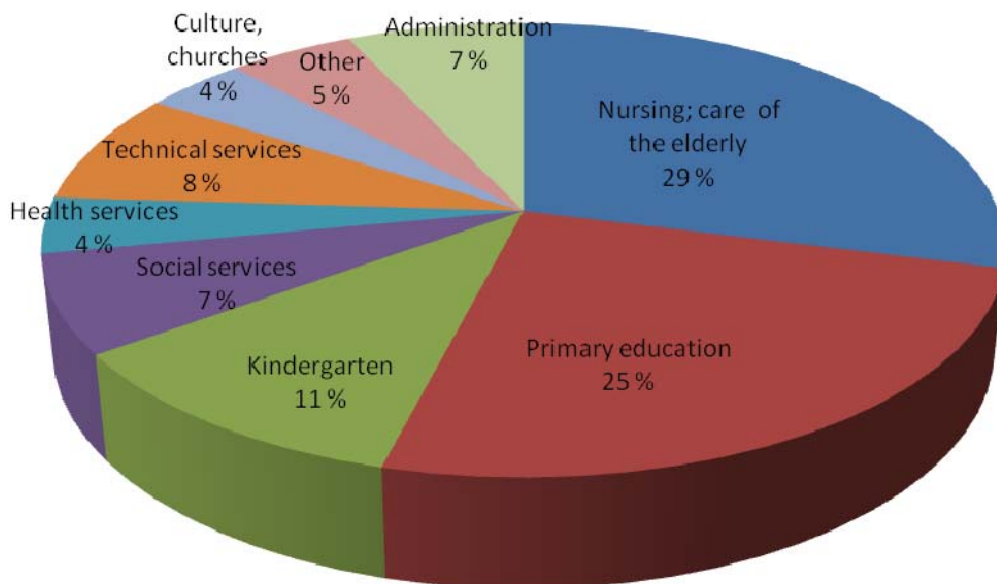


Figure 2: Distribution of expenditures 2007 - Municipalities

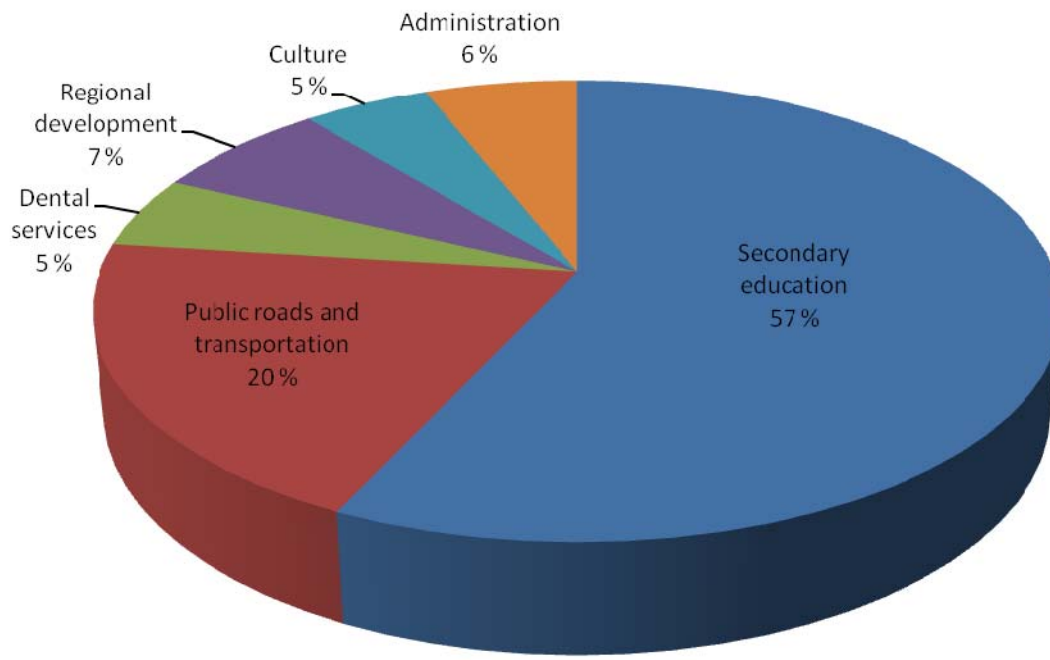


Figure 3:
Distribution of expenditures 2007 - Counties