BLOCK GRANTS AND EARMARKED GRANTS: THE NORWEGIAN EXPERIENCE

Lars-Erik Borge
Department of Economics
Norwegian University of Science and Technology
NO-7491 Trondheim, Norway
e-mail larseb@svt.ntnu.no

Abstract

The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivations for the reform was to establish a simpler and more transparent grant system, a more fair distribution of resources across local governments, and to strengthen local democracy and improve efficiency. Ever since the introduction the block grant system has been under pressure, and earmarking has steadily increased. The purpose of this paper is to tell a story on how the design of earmarked grants has evolved during the last 20-25 years. There has been a trend towards more efficient earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of the prioritized service without creating leakages towards other services. The new schemes have reduced the political frustration at the central level by increasing the correspondence between intentions and results, but have lead to a more complicated system that in the longer term may lead to less local innovation and initiative.

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1. Introduction

In Norway, as in the other Scandinavian countries, local governments are the main providers of welfare services, i.e. education, health and social services. The local governments have substantial discretion in the allocation of resources across between service sectors, but are heavily regulated on the revenue side. The main revenue sources are local taxes and block grants from the central government. Most taxes are of the revenue-sharing type, where effective limits on tax rates have been in place for the last 30 years. Local government revenue amounts to 15% of GDP.

The purpose of this paper is to tell a story on the development of earmarking since the introduction of the block grant system in 1986. Section 2 presents the empirical background, and documents that the block grant system has been under pressure ever since it was introduced. The increased reliance on earmarked grants can be understood as the outcome of a blame game between central and the local government. Sections 3-5 is devoted to how the design of earmarked grants have changed over time; from inefficient earmarking, via earmarking with leakages, and finally to earmarking without leakages. Finally, section 6 presents some concluding remarks.

2. Empirical background

The introduction of the block grant system in 1986 was a major reform of the financing of the local public sector in Norway. The block grant system is based on objective criteria and replaced 50 earmarked grants. The main motivations for the reform was to establish a simpler and more transparent grant system, a more fair distribution of resources across local governments, and to strengthen local democracy and improve efficiency by giving local governments more discretion in the allocation of resources across services. The main elements of the block grant system are tax equalization, spending needs equalization, and a judgment grants (to take account of specific local conditions not captured by the objective criteria).

The block grant reform was considered to be a first step in further reduction of earmarking. The main idea was to abolish many of the remaining earmarked grants and to increase the amount of resources distributed through the block grant system. Local government priorities should, if necessary, be affected through regulation. In a larger picture, the block grant reform

was one of several attempts of decentralizing. The Local Government Act was revised in 1992 to give the local governments more freedom to organize their decision making and production. The liberalization of the credit market during the 1980s meant that the control of local public investments through public banks was eliminated.

Table 1: The development of block grants and taxes, 1986-2008

Year	Block grants as share of total grants (%)	Taxes and block grants as share of total revenue (%)
1986	83.5	83.9
1987	86.9	85.0
1988	84.0	82.1
1989	81.6	80.3
1990	79.7	79.5
1991	73.5	76.1
1992	72.2	75.6
1993	69.6	74.4
1994	71.3	75.6
1995	69.8	74.5
1996	68.3	74.1
1997	68.5	73.9
1998	64.1	72.2
1999	61.4	70.1
2000	61.8	69.8
2001	59.4	69.7
2002	78.4	75.4
2003	73.6	74.6
2004	61.4	73.0
2005	58.3	73.0
2006	57.9	73.0
2007	56.5	71.6
2008	55.4	71.2

Table 1 provides information on the development of earmarking since 1986. Two key figures are reported in the table. The first indicator of the degree of earmarking is block grants as share of total grants, while the second is taxes and block grants as share of total revenue. The motivation for the second indicator is that there is little difference between taxes and block grants in the Norwegian context where local tax discretion is very limited. Consider a case where a reduction in the block grant is “compensated” by more local tax revenue. It is then unreasonable to label the reduction in the share of block grants in total revenue as “more earmarking”. The second indicator, the share of block grants in total revenue, has the advantage that it is unaffected by such a shift between block grants and local taxes. On the

other hand, it has the disadvantage that it is affected by the development of other revenues (mainly user charges).

The two indicators in table 1 basically give the same picture. Except for the first year after the reform, the degree of earmarking has continuously increased during the last 20 years.[1] Both the share of block grants in total grants and the share of taxes and block grants in total revenue are clearly reduced. The year 2002 is the main exception to the general trend. Then both the share of block grants in total grants and the share of taxes and block grants in total revenue increased sharply. However, the shift does not reflect less earmarking of particular services, but a shift in the division of labor between the counties and central government. The central government took over the responsibility for hospitals, a service where the degree of earmarking was relatively high.[2]

The increased reliance on earmarking means that the block grant system, and the logic underlying it, is constantly under pressure. In the Norwegian context with limited local tax discretion, the logic of the block grant system is that the central government is responsible for the total revenues of the local public sector (correspondence between revenues and responsibilities), while the local governments are responsible for the allocation of resources between different services. In practice the system invites to blame avoidance and unclear responsibilities. When local politicians are confronted with a "crisis" in service provision, they immediately blame the central government that sets the financial constraints. On the other hand, the central government will try to shift the responsibility back to the local governments, arguing that they should get more value for their money or give higher priority to the service concerned. If the "crisis" grows large and include a large number of local governments, it may be difficult to avoid supplementary grant increases. From the point of view of the central government, earmarking can be seen as a way to avoid the blame game.

[1] The table overstates the reduction in the indicators from 1987 to 1988 because the figures for 1986 and 1987 are not directly comparable to the figures for the later years. However, also with comparable data it is evident that the downward trend started in 1988.

[2] The sharp decline in the share of block grants from 2003 to 2004 reflects that the central government took over the responsibility for some social services with a relatively low degree of earmarking. In addition, the introduction of VAT-compensation was financed by a reduction in the block grant. The second indicator, taxes and block grants as share of total revenue, is adjusted for the introduction of VAT-compensation.

3. Inefficient earmarking

Until 1994 the spending needs equalization consisted of sectoral block grants, i.e. one grant for each major service sector (like education, health care, etc). The central government used these sectoral block grants to signal their priorities. If it wanted higher spending on education, the sectoral block grant for education was given higher growth than the other sectoral block grants. However, the signals from the central government did not impose any formal restrictions. Since the local governments were still free to spend the grant as they liked, it is no surprise that the signaling through sectoral block grants turned out to be ineffective. At best the sectoral grants gave the central government a short term political gain when the budget was put forward, but this backfired during the fiscal year if the local governments did not give priority to the sectors with the highest growth in grants.

Table 1: The inefficiency of earmarked block grants

	Initial situation	Block grant increase	Earmarked grant for service B
Revenues			
Local taxes	50	50	50
Block grant	50	100	50
Earmarked grant service B	0		50
Spending			
Service A	50	75	75
Service B	50	75	75

At a later stage a slightly stronger form of earmarking was introduced – so called earmarked block grants. These grants are allocated according to objective criteria (like a block grant), but is earmarked in the sense that the money has to be spent on a particular service or activity. The purpose of table 1 is to illustrate that also earmarked block grants tend to be ineffective. The point of departure is a situation where the local government has two revenue sources; local taxes and block grants. Total revenue is 100 (50 from each revenue source) and the local government allocates an equal amount of 50 to the two services (A and B).

Then consider a situation where the central government wants to strengthen service by B introducing an earmarked block grant of 50 to this service. However, the earmarked block has exactly the same effect as an equal increase in the general block grant. This is easily seen by first considering an increase in the general block grant, and for simplicity we assume that the

local government's response is to increase the spending on both services to 75. Then consider the introduction of an earmarked block grant of 50 to service B. From the analysis of the block grant increase we know what the local government wants to do – to increase spending on both services to 75. This can be achieved also in the case of earmarking by spending the earmarked block grant on service B, reducing the funding of service B through taxes and general block grants to 25, and to increase the funding of service A through taxes and general block grants to 75. The condition for receiving the earmarked grant is met, and it evident that it works as a block grant.

Table 1 shows that earmarked block grants are likely to work as general block grants when they are broad (in the sense that the earmarking applies to large service sectors such as education and care for the elderly) and the amounts are small relatively to what the local government would have spent anyway. They may have some effectiveness when they are narrow (school books, cultural activities for the elderly, etc) and the amounts are large relatively to what the local governments spend. It could also be argued that sectoral block grants and earmarked block grants are more effective in the short term than in the long term. In the short term the cutback in own financing may be too visible, but in the longer term the counterfactual situation is harder to detect.

Sectoral block grants and earmarked block grants must be understood in a political context, and more precisely as a response to a general "crisis" description in the media. Borge and Rattsø (1998, p. 35) argue that ministers can gain positive publicity in the press by granting a relatively small amount to solve problems raised in the tabloid press. In the short term the ministers appear energetic, vigorous and able to solve problems. In the longer term however, the ministers (if they are still in office) may have a hard time explaining why the policy does not result in better services. My conclusions is that the inefficiency of the sectoral block grants and earmarked block grants (mostly used in care for the elderly) lead to much political frustration, and the ministers started to look for more efficient grant schemes.

4. Efficient earmarking with leakages

In the economic literature on intergovernmental grants (e.g. Rubinfeld 1987, section 6.2) it is emphasized that efficient earmarking should affect relative prices, i.e. they should be of the matching type. The impact of an open-ended matching grant is illustrated in figure 2. The

local government provides two services; the prioritized service and other services. The initial budget constraint is BB and the actual allocation is in point A (with spending P_0 on the prioritized service and O_0 on other services). The introduction of a matching grant reduces the relative price of the prioritized service and shifts the budget line to BB_1. Both the substitution effect and the income effect leads to increased provision of the prioritized service. The matching grant is more stimulative than a block grant because of the substitution effect (price effect), and in this sense the matching grant is efficient in terms of affecting local priorities.

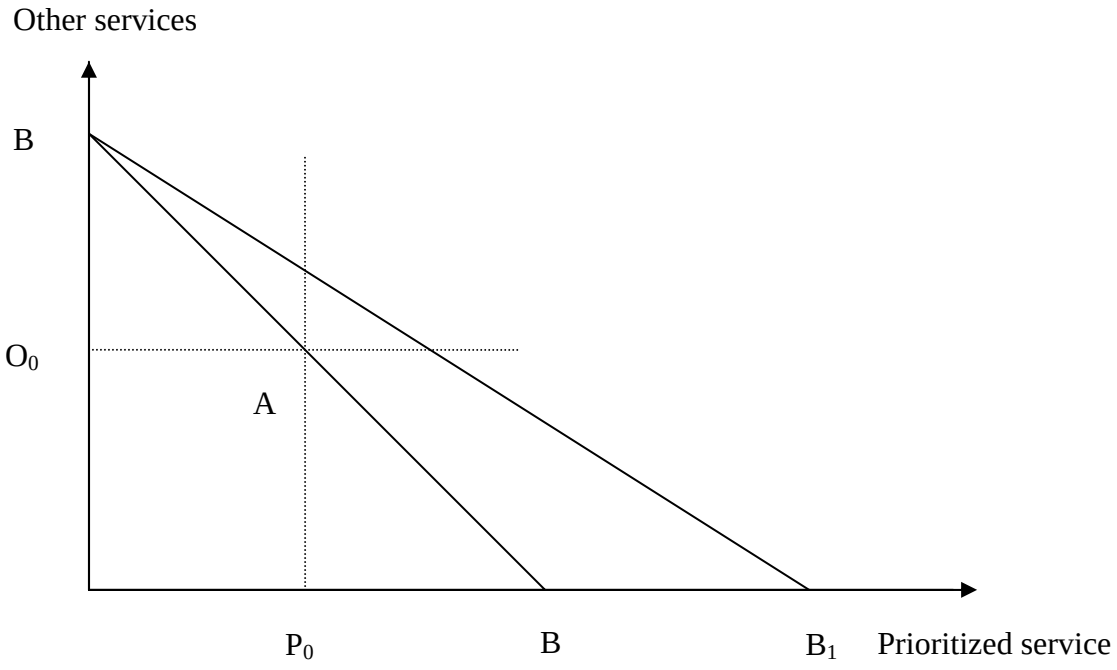

Figure 1: The impact of an open-ended matching grant

The effect on other services is more unclear, and depends on how much the prioritized service is expanded. If the expansion is large (the new allocation is southeast of the crossing between Q_0 and BB_1), the impact on other services is negative. But if the expansion is small (the new allocation is between the crossing P_0-BB_1 and Q_0-BB_1), other services are expanded as well. It can be shown that that provision of other services will increase (decrease) if the demand for the prioritized service is inelastic (elastic) with respect to price. A large empirical literature documents that demand for local public services tend to be inelastic with respect to price. Consequently, an open-ended matching grant will to some extent leak out to other services.

For the local government the leakage to other services is an optimal response, but for the central government the leakage may be politically problematic. In the budget process it specifies the (expected) amount of money to be distributed through the matching grant, and the minister must argue that this amount of money is needed to improve the prioritized service. But if it turns out that the local spending increase on the prioritized service is lower than grant increase, it becomes the minister's job to explain why. He can to some extent blame the local governments for not being loyal to the intentions of the grant increase, but it is difficult to avoid responsibility for an improper grant design that explains the lack of correspondence between intentions and outcomes.

A matching grant for child care has been in place for a long period of time. In the late 1990s the matching rate was increased to increase coverage and to lower user charges. It turned out that the impact on coverage and user charges was modest, and that the increased spending on child care was much lower than the grant increase. The discrepancy between intentions and actual policy change received much media attention. The result was a blame-game between the central government and local governments. The local governments argued that they did nothing wrong since total spending on child care largely exceeded grants for child care, while the central government emphasized that the spending increase was lower than the grant increase. Again the frustration led to a look for more efficient ways of affecting local priorities.

5. Efficient earmarking without leakages

In recent years the central government has used so-called action plans to increase provision of particular services. Action plans are used in care for the elderly, schools, and child care among others. Action plans are temporary and includes earmarked grants as financial mean. In order to avoid leakages many of the grants only cover new service provision.

Figure 2 illustrates the case of a matching grant for new service provision. This could be either an investment grant or a grant for current expenditures related to increased expenditures. Again the initial budget line is BB and the initial allocation is in A. The matching grant for new services provision shifts the budget line to BAB_1, and the new allocation will be on the segment AB_1 of the new budget line. It appears that the matching grant increases the provision of the prioritized service and reduces the provision of other services (the leakage is

eliminated). The larger the expansion of the prioritized service, the larger is the cutback in other services.

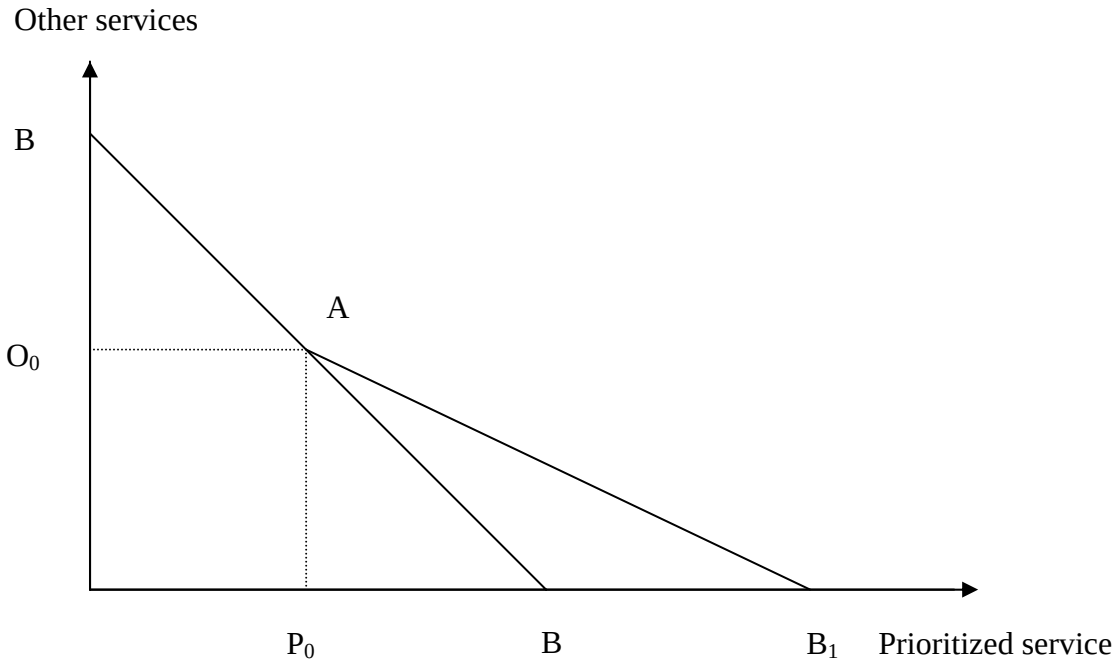

Figure 2: The impact of a matching grant for "new" service provision

The benefit of a grant for new service provision will vary across local governments depending on the initial level of service provision. It can be seen from figure 2 that the higher is P_0, the less will the budget line shift out. Local governments that have given high priority to the prioritized service will be "punished" since they are less able to take advantage of the new grant program. This may have severe negative consequences in the longer term. Local governments will be reluctant to develop the services when they fear to lose out when the next central government action plan is implemented.

Borge and Rattsø (2008) present a more formal theoretical analysis of actions plans and temporary matching grant programs. The model assumes intertemporal consistency and separates between three periods – before, during and after a matching grant program. Given a benchmark of block grant financing, three types of matching grants are analyzed – matching current expenditure, announced investment grant and unannounced investment grant. Matching current expenditure is the conventional way of handling matching grants and with the standard price and income effects. Investments to expand capacity are neglected in the

standard grant analysis, but matching grants to stimulate investments are important in practice. Including the investment decision also highlights the possibilities local governments have of shifting resource use over time and the importance of expectations.

The analysis shows how announced investment grant leads local governments to reduce their investments before the grant program. This is avoided by unannounced investment programs, but they will have the effect that local governments giving priority to the relevant service will be 'punished' since they are less able to take benefit of the grant (as above). Investment grants imply large changes in service, while matching of current expenditure offers stability in the service allocation.

Borge and Haraldsvik (2008) provide an empirical analysis of the action plan for the elderly (APE) that was implemented in 1997 to increase capacity and improve service standards within the care for the elderly sector. The main financial element in APE was a temporary investment grant for nursing homes and specially adapted dwellings. Consistent with figure 2, they find that the care for the elderly sector is expanded at the expense of other services, in particular child care. For the local government with the largest utilization of APE the predicted reduction in child care coverage (during 1997-2005) is 7-8 percentage points (compared to a local government that did not utilize APE). For a local government with average utilization the effect is nearly 2 percentage points. Given the temporary nature of APE, it is of interest to analyze whether they have any impact on the budgetary balance. One may suspect that a temporary grant program leads to a "spend now"-attitude that may reduce the budgetary balance. The authors show that for a local government with average utilization APE contributed to a reduction in the net operating surplus corresponding to 1.4% of revenues.

6. Concluding remarks

The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivations for the reform was to establish a simpler and more transparent grant system, a more fair distribution of resources across local governments, and to strengthen local democracy and improve efficiency. Ever since the introduction the block grant system has been under pressure, and earmarking has steadily increased. The purpose of this paper was to tell a story on how the design of earmarked grants has evolved during the last 20-25 years. There has been a trend towards more efficient

earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of the prioritized service without creating leakages towards other services. The new schemes have reduced the political frustration at the central level by increasing the correspondence between intentions and results, but have lead to a more complicated system that in the longer term may lead to less local innovation and initiative.

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