

Chapter 9:
Vertical Imbalance and Fiscal Behavior in a Welfare State: Norway

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I. Introduction and summary

The local public sector in the Scandinavian countries is an integrated part of the welfare state. The main welfare services (schooling and health care) are publicly provided and decentralized to avoid overload of the central government. The design implies delegation rather than decentralization, and can be called ‘administrative federalism’. Local and county governments primarily are agents of the central government. A major objective of the welfare state is to provide uniform welfare services across the country, and the decentralized implementation is consequently combined with centralized financing, mandating, and detailed service regulation. Hierarchical administrative controls impose fiscal discipline on the system. In fact, centralized financing and control precludes any disciplining role of the credit market. Land and housing markets reflect regional imbalances in labor markets, and are not seen as responsive to local public performance. The model allows little room for local democracy and accountability.

The combination of centralized financing and redistributive welfare services creates a double common pool problem. The costs of the welfare services are internalized neither at the individual level nor at the local government level, and a spending pressure towards the center results. This is obviously a serious challenge for the national political system. Even more so because the central

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government has all the instruments needed to influence the economic situation in each municipality and county. Vertical fiscal imbalance and welfare redistribution are expected to invite opportunistic behavior from the local public sector. Local governments can exploit the national political concern for the access to and quality of the welfare services. It seems like the political system has been able to withstand this pressure for outright local fiscal indiscipline, although rapid overall local public spending growth must be understood in light of this spending pressure. While the Scandinavian party systems are highly fragmented as a result of proportional representation, the parties themselves are efficient in internalizing their representatives into a national policy.

The broad evaluation presented here is that the resulting budget constraints in general are hard and that individual strategic and distorted behavior from municipalities and counties, while present, is not important in practice. The centralized regulation, oversight and control imply that localities have limited room for strategic behavior. Given the availability of public information about economic conditions and performance, it is hard to 'break out of the pack' for any locality. The strategic problems of vertical fiscal imbalance are of more collective character. The common pool aspects and the associated lack of local accountability reduce the pressure to hold down costs and restructure services to changing demand. Productivity growth is slow and competition and privatization in the service production is limited. Moral hazard problems are more likely within local governments, where strong internal and external interest groups can take advantage of a weak local political system. The central regulations help keep the local budget constraints hard.

This will discuss the broader experiences with vertical fiscal imbalance in the welfare state. A broad outline of the Scandinavian type of administrative federalism is given in section 2. The rest of the chapter concentrates on Norway. Hierarchical and political mechanisms of control are addressed

in sections 3 and 4, while their consequences for fiscal balance are shown in section 5. Section 6 discusses problems of bailout and strategic behavior. The concluding section 7 contemplates reform.

II. Scandinavian style administrative federalism

The understanding of decentralized government in the Musgrave-Oates-Tiebout tradition assumes local public goods, mobility and benefit taxation. This model is far away from the Scandinavian approach to fiscal federalism. First, the local public sector is responsible for welfare services with strong redistributive characteristics, and local public goods only take a small share of local spending. Second, mobility of the population is low and local jurisdictions are heterogeneous with respect to preferences for welfare services and local public goods. Third, financing is centralized and dominated by central government grants and regulated income tax revenue sharing. When the local public sector is responsible for the provision of welfare services, new issues of decision making and distribution arise. The literature does not offer clear criteria for the handling of such ‘merit goods’ (Musgrave, 1959) or ‘redistributive services’ (Foster et al., 1980). The system can be described as administrative federalism, since the design is rooted more in administrative delegation than fiscal federalism.

Decentralized government in the Scandinavian countries increased its importance in the economy with the expansion of the welfare state after the second world war. Presently local and county governments represent about 2/3 of all government service production or in the order of 15-20 % of GDP. Most of this spending is mandated and relates to welfare services such as kindergartens, primary school through high school, primary health care and hospitals, and care for the elderly. In addition, the local public sector provides more typical local public goods such as

infrastructure and planning. The functioning of this system is analyzed in various articles in Rattsø (1998). In particular Lotz (1998) reports on the frustration among Scandinavian economists that the guidelines from local public finance theory are of so little relevance.

A basic objective of the Scandinavian welfare states is to arrange equality and standardization of welfare services across the country, and national politicians are held accountable for its performance. Decentralization of the welfare state is consequently puzzling. This delegation must first and for all be understood as a way to avoid overburdened national bureaucracy. But also the local public sector can help adjust welfare services to local conditions. Redistributive welfare services have local characteristics that make local political choice important. The choice of school structure (size and location) is a case in point. Local and county governments may have informational advantages of preferences and costs and can better take into account local characteristics.

While welfare spending is decentralized, the financing is strongly centralized. Partly the centralized financing represents instruments of national control and partly the desire to equalize the provision of welfare services. The welfare services are to be distributed independent of the economic conditions of the households and the localities involved. The centralized financing also is the result of inadequate tax bases for local taxation. Property taxes and user charges hardly anywhere account for the financing needed to cover 15-20 % of GDP, and income tax revenue sharing adds necessary funds. Income tax is less suitable as a benefit tax, and in particular when it is shared between local, county and central governments. Since income levels available for taxation are very different in urban and rural areas, a comprehensive tax equalization system de-links the relationship between local income tax rate and income tax revenue. Expenditure equalization grants, distributed partly as block grants and partly as matching grants, add to the centralized control.

This kind of vertical fiscal imbalance has been a source of concern in the literature because of the associated common pool problem. Decentralized spending with centralized financing through grants and regulated tax revenue sharing implies that the population in each local government pays only a small share of the total costs of the local service production. At the same time, local governments can take advantage of the central government concern for welfare service levels. Central government policies to deal with distribution under decentralization opens up the possibility of a strategic game between the local and the national levels. As will come clear, discipline is imposed in Norway primarily by way of hierarchical controls.

When welfare services are decentralized, a double common pool problem appears. Welfare services are provided free of charge to specific age groups (care for the elderly) and geographic areas (schools) and financed by general taxation. It follows that the groups benefiting from the services pay only a small share of the costs. At the next level, the local governments financing the services get their funds primarily from a centralized system of tax sharing and grants. Weingast, Shepsle and Johnsen (1981) present the spending pressure arising in this situation. Even competition between local governments can work badly with redistributive services, since new incentives are created to attract 'cheap' taxpayers and discourage the entry of 'costly' immigrants.

Interestingly, the political leadership of the Scandinavian countries and certainly the ministries of finance see centralized financing as a way of holding down public spending. Spending pressure is already there with redistributive welfare services, and they see the central government as more able to handle the pressure than local governments. The disadvantages of centralized financing are handled with strict hierarchical administrative controls. The design is consistent with recent international evaluations. Von Hagen and Eichengreen (1996) conclude that 'fiscal restrictions do prevail in states characterized by a high degree of vertical fiscal imbalance'. Qian and Weingast

(1997) argue that regulations by hardening the local budget constraint also preserve market incentives. Carlsen (1994, 1998) develops theoretical models to capture strategic interactions and arguments for regulations in this setting. In this context, the present regulations of the local public sector can be seen as a way of avoiding bailout by limiting the room to maneuver to distort local decisions.

III. Centralized financing of decentralized spending: Hierarchical controls

Norway is a small and rich welfare state. The economy is based on raw materials (oil, also fish). The public sector directly controls about 50 % of GDP, including welfare state policies such as free health care and schooling and a comprehensive social security system. It is a unitary state, but the local public sector is given a strong and politically independent position by law. Also the representative democracy is decentralized, and the 435 municipalities and 19 counties elect their own local and county councils with proportional representation and multiple (about 10) parties. The large number of locally elected politicians (about 16.000) implies that decentralized government is a forceful voice in national politics. Since about 20 % of the labor force (about 450.000) work in the local public sector, it is a strong institution socially and economically also. Key data are given in the Table 1 fact sheet.

[TABLE 1 ABOUT HERE].

As mentioned in the introduction, centralized financing and financial controls are the key mechanisms of fiscal discipline. Since local and county governments are agents of the central

government, they are not treated as independent sovereign entities at the financial markets and they basically meet the same financial conditions (assuming a central government guarantee). Since mobility is low, land and housing markets are influenced by more permanent regional imbalances, and local fiscal performance is of little importance. The financial controls are related to the following main elements:

- Grants represent about 40 % of the revenues. Most of the grants are distributed as block grants based on objective criteria, but a variety of matching grants are in place to promote the detailed ambitions of national politicians. A residual discretionary grant is distributed annually based on 'judgement' of the economic conditions in each locality.
- About 45 % of the revenues are based on income tax and wealth tax shared with the central government. Tax rules are determined in the national parliament and local tax rates are limited to a narrow band. All local governments apply the maximum rate (since 1979) and in this situation the tax revenue works as a block grant, except that local governments can influence the tax base over time.
- The property tax is not available to all local governments (in practice 200 of 435 municipalities have property tax), since it is restricted to urban areas and certain facilities (notably power stations). In addition, the property tax rate is limited to a narrow band.
- User charges are of rising importance and are now approaching 15 % of revenues. They are regulated by law and cannot exceed unit costs, but the share of costs covered and the cost levels do vary.
- The Local Government Act requires that operational budgets balance inclusive of interest payments and regular installment of debt. Investment level is decided locally, but total loan financing must be approved by the central government. Actual deficits are allowed to be carried over, but must be paid within 2 years.

The local revenue sources, local taxes and user charges, amount to nearly 60 % of total revenue. This figure is high compared to many other European countries, and may delude an external observer to think that the Norwegian system of financing is rather decentralized. To get a proper

understanding of the system, the central regulation of the local taxes must be taken into account. In practice county government revenues are determined by these regulations (given the income tax base), while local governments only apply some discretion in property taxation and user charges, also these within strict regulations. The regulations must be understood on the background of the serious horizontal income imbalance among the municipalities and the counties. The average share of local taxes in total revenues is about 46 %, and the heterogeneity with respect to revenue bases is illustrated by the fact that this share varies from 11 to 75 % across the municipalities and from 25 to 63 % across the counties.

Formally the local and county governments have the discretion to set the income tax rate within a narrow band, but they all use the maximum tax rate. The reason why they all hit the roof is strategic. If any local or county government reduce the income tax rate below the maximum, it expects to be punished by the central government for being 'too rich'. Such a policy of punishment has never been announced, but central government has discretionary grants and can also influence local revenues through various ad hoc policy 'packages' to promote new services. If local governments are seen as sufficiently rich to reduce the income tax rate, they are in a weak position to gain from such marginal funds. The central government seems not to worry about this element of soft budget constraint, and is happy to control the level of revenue in each and every local and county government.

The important role of grants has been motivated by equalization and by the desire to influence the local government service production. The wish to redistribute income has been taken care of by tax equalization and needs equalization schemes designed as block grants. The tax equalization attempts at raising the revenues of municipalities and counties with weak tax bases. The high ambitions of the system imply that few of them have much incentive to improve their tax base. Interestingly, the

comprehensive grant system oriented towards equalization has created new inequality. Since regional policy aspects are built into the criteria, the periphery, and in particular small municipalities, has been overcompensated. The result is a divide where urban areas are relatively rich in private income and poor in public services, while the periphery is relatively poor in private income and rich in public services. The effect is similar to Rodden's (1999) description of Germany where 'the last shall be the first'. In addition to the complex equalization system, the services have been controlled by an array of matching grants. The matching grants typically have been introduced to promote new services and expand old services with central government priority.

The financial conditions of the local public sector are decided by the national parliament as part of the annual national budget and then related to macroeconomic stabilization policy. Prior to each fiscal year, the central government announces a desired growth of total local government revenue, and of tax revenue and block grants separately. The parliament sets maximum income tax rates and grants according to this overall revenue target. The distribution of block grants among local governments also is decided prior to the fiscal year. Given the nationally determined economic conditions, the local governments produce their own budgets. The local political decision making is organized around the budget process.

The local budgets are regulated by the Local Government Act, and the main requirement is operational budget balance. In the budget, current revenue must cover current expenditures, interest payments and regular installment of debt. Loan financing of current spending is not allowed. The final budgets are controlled and approved by the central government. If the budget implies an operational deficit, it will not be approved and is sent back to the local government for revision. A balanced budget ex ante does not rule out an actual deficit when the account is settled. Income tax revenue during the year and expenditures linked to rules and rights (like social support) may deviate from the

budget. Actual deficits are allowed to be carried over, but as a main rule they must be 'repaid' within 2 years. In understanding with the central government, the local council can extend the period to 4 years if faster repayment has dramatic consequences for local service provision.

The balanced budget rule is the key to sound finances and efficient resource use. The benefit principle with inter-temporal efficiency is encouraged since investments are allowed to be financed by loans. The rule may reduce intertemporal flexibility, and service provision may be unstable when current spending is strongly linked to current revenues. However, central government smooth local government revenue over time and local governments typically hold 'rainy-day' funds to smooth out shifts in revenues, although this is not required. Local governments know that larger loan-financed investment means future debt service to be covered by current revenues. Even more important, they know that investments typically start up new service production that requires future current spending for labor and materials.

According to Owens and Norregaard (1991), central governments in most OECD economies control the level of local government loan financing and in some countries even the purposes for which loans can be raised. Compared to the OECD area, Norwegian local governments have large discretion in investment policy, given the constraint that interest payments and debt installment are included in the operational budget balance and that total loan financing is approved. The system is meant to encourage decentralized accountability and priority within a system of centralized financing with hard budget constraint.

In addition to the financial controls, the welfare services are regulated in detail by law. The regulations involve coverage (example: all children in primary school), standards (example: class size) and working conditions (example: children per employee in day care). Local governments must satisfy these rights, which are important in schooling, health care and social aid. Rights like these

defined by national law have grown more popular. The administrative regulations integrate local governments in national sectoral control systems that cut across the national-local divide. This leads to a segmentation of the system whereby in particular education and health care are quite autonomous sectors relative to local democratic control. The regulations can be said to modify the vertical imbalance. Even if local and county governments take spending decisions regarding 15-20 % of GDP, the regulations imply a sort of centralized spending that matches the centralized financing. Centralized financing must be understood in this context of administrative regulation of welfare services.

IV. The political control mechanism

Norway is a multi-party parliamentary system with proportional representation from 20 districts, and with about 8 major political parties with nation wide support. The parties nominate candidates for the national parliament in each of the districts, and elections are held every four years. The party composition of the parliament is the major determinant of national policy, and the parliament is quite fragmented with respect to parties. The degree of fragmentation is important for the 'strength of the government' (Borge and Rattsø, 1999) - establishment of majority or minority government and whether the government is based on one party or a coalition. A majority party government does not need to bargain with other parties in parliament in order to implement its desired policy. The parties are strong, and they seem to internalize the regional dimension of politics. Coalitions of representatives from regions across party lines are seldom observed in the national parliament. Still regionalism is the key political battleground, in particular with heated conflicts concerning location of government institutions.

At the local level the political system is a miniature of the national. Elected local and county councils are dominated by the national parties, and the election results reflect national politics, although with geographic variation. Also some non-party groups are represented, typically in the periphery. The local and county councils do not work as a parliamentary system (except for Oslo). Instead, an executive board is elected among the members of the council, with proportional representation of the parties (and non-party groups) in the council. The system of joint rule tends to facilitate consensual properties, and allows for a more open struggle regarding the political priorities. The mayor and the deputy mayor are elected by and from the council, and are the leaders of the executive board. The constellation behind the political leadership will typically have a majority in the executive board.

The local political and administrative leaderships first and for all communicate with the regional commissioner (central government representative in each county) and the Ministry of Local Government. Local demands for funds are channeled into the regular budget process run by the ministry. It is very seldom that regional representatives in the parliament are mobilized by a single local authority to lobby for more funds. Even when the same party controls the central and the specific local government, it is not considered acceptable to give special favors. Exceptions from this idyllic situation are discussed in section 6.

The functioning of the national political system with respect to decentralized government financing has been analyzed by Borge and Rattsø (1997, 1999). Their point of departure is a benchmark demand model of public services emphasizing price-, income- and congestion-effects. The demand model is modified to represent the common pool problem resulting from vertical fiscal imbalance. The benefits of decentralized government spending are concentrated to each municipality and county, while the costs are carried by general taxation and to a large extent financed by central

government grants. The national political system must internalize the costs of the local public services. Different from the standard universalistic model of the US congress, in parliamentary democracies party fragmentation of the parliament and coalition politics are important for the internalization of the costs. The econometric analysis confirms that political strength (measured by party fragmentation and coalition types) is important for the decentralized spending growth. A minority coalition government implies 20 % more decentralized spending than one party majority government in the long run.

In addition to political strength, political ideology of the majority in parliament influences the size of government spending. A socialist majority drives up the spending level. Since strength has been associated with socialist majority because of fragmentation on the non-socialist side, voters have faced a tradeoff between ideology and strength. Interestingly, our estimates indicate that strength dominates over ideology in the sense that non-socialist majorities, being more fragmented, have contributed to higher decentralized spending. Among the economic determinants of local public spending, strong support is given for Wagner's law. The share of the local public sector in the national economy increases as income per capita increases.

Political strength also has been investigated at the local level, and has been operationalized as the political constellation (majority or not, one party or coalition) behind the mayor and deputy mayor by Kalseth and Rattsø (1998). They find that political strength holds back the local administrative costs. Falch and Rattsø (1999) show that political strength in the counties, measured by party fragmentation in the councils, has held down costs and allowed for more student enrollment in high schools. Their study includes a measure of the local spending pressure. Municipalities campaign for high schools and counties with many small municipalities are expected to have more spending pressure. The econometric results confirm reduced average population size of municipalities drive up school spending and that the effect is moderated by political strength. Borge (1996) extends

the analysis to budget deficits. Political strength is measured in several ways, and a strong political leadership is characterized by majority control, little party fragmentation in the local council, and small ideological differences within the ruling coalition. Whatever measure is applied, the message is that municipalities with a weak political leadership tend to have larger budget deficits (including investment spending). Political strength thus has a substantial impact on budget responsibility at the local level.

V. Evaluation of fiscal performance

The design of the Norwegian system of local public finance attempts at establishing a hard budget constraint for individual municipalities and counties. Given that the central government basically determines the balance between private and local public consumption in each locality, the decentralization is meant to encourage three types of efficiency - allocative efficiency between the different local public services, cost efficiency by the incentive to produce good services given the revenues, and intertemporal efficiency by allowing borrowing to finance investment spending. Fiscal discipline is meant to result from the financial controls including central government approval of new loans and the balanced budget requirement.

Local public investment amounts to about 50 % of total public investment. The share is considerably lower than the local share of public employment, since local services are labor intensive. Fixed capital investment generally represents about 10 % of current revenue, and borrowing finances about 50 % of investments on average. A positive operating surplus finances about 35 % of investments, while the rest is mobilized from internal funds. The average debt-revenue ratio is about 30 % and has fluctuated between 20 % and 40 % since 1980, primarily due to cyclical revenues. Borge and Rattsø (1998b) investigate the details of the borrowing regime.

While the investment share of revenues was strongly increasing after the second world war, it has been stagnating and declining since about 1970. A similar experience has been named the 'infrastructure problem' in the US (Hulten and Peterson, 1984). The stagnation of investment can be the result of (more) myopic decision making or central controls. An analysis of aggregate local government investment throws some light on the intertemporal decisions taken. Rattsø (1999a) studies whether the recent stagnation of investment reflects sensible response to future revenue growth and demographic shift or imperfections in the decision-making system. The analysis applies an intertemporal optimization model with rational expectations and concludes that unexpected changes of GDP and unemployment have been important determinants of investment. The stagnating GDP growth has reduced the growth in investment spending, even when the central government has kept the revenue growth of the local public sector high and stable. Stabilization of local revenue growth has not led to stable investment growth. The investment decisions of the local public sector emphasize the underlying economic development of the country more than its own revenue growth. At the same time, greater volatility in macroeconomic conditions has led to fluctuations in local public investment. The results are not inconsistent with the forward-looking model.

In the context of financial controls, differences between localities are important, and the share of investments financed by borrowing varies substantially across the local units. 10 % of the municipalities had a borrowing rate above 70 %. There is a strong positive correlation between per capita revenues and operating surplus. Large revenues mean that more internal funds are available for fixed capital investment. Furthermore, municipalities with revenue and surplus above average invest more and borrow less. A low borrowing-revenue ratio is associated with high revenue levels.

The international literature about the empirical effects of balanced budget rules is limited. Poterba (1995) and Inman (1996) survey the recent literature on US states. The U.S. states form an

interesting case because the shaping of the balanced budget rules varies widely across states. The study by Bohn and Inman (1996) is particularly interesting because it helps to identify exactly what attributes of the balanced budget rules that are of importance for the actual deficit. The empirical analysis indicates that the most important attribute is whether the balanced budget requirement is imposed ex ante or ex post, i.e. whether deficits are allowed to be carried over or not. Effective rules do not allow deficits to be carried over to the next fiscal year. Rules that require a balanced budget ex ante and allows deficits to be carried over, seems to be less effective.

In Norway, regulation of revenue sources and rigid expenditure commitments (like employment contracts) do not allow much adjustment on the current account. It follows that the immediate effects of shocks on the current deficit can be relatively large. In addition, and according to Bohn and Inman, the budget balance rule is weak since actual deficits are allowed to be carried over. An econometric study of local government responses to shocks (Rattsø, 1999a) confirms that current expenditures and revenues are unaffected by deficit shocks. The investment level is the main shock absorber. When fiscal imbalances have not been important in practice, the limited size of the shocks is an obvious explanation. The shocks experienced are often related to changing central government policy. Also the weak deficit rule is combined with the requirement that the deficit carried over must be paid down within two years (or four in exceptional cases). The strict application of this rule seems to be sufficient to keep the deficits under control.

Still deficits are regularly experienced, even when the law requires balanced budgets. Deficits may reflect revenue- and expenditure shocks during the fiscal year turning a balanced budget into an actual deficit. Or the submitted budgets may be balanced by deliberate overestimation of revenues and/ or underestimation of expenditures. It is hard to separate between shocks and creative budgeting. If deficits are mainly the result of revenue shocks, one would expect revenues to be more

volatile in municipalities that run deficits frequently. This hypothesis is evaluated by Borge (1996). He separates between municipalities that did not have any deficits in the period 1981-90, and municipalities that had a deficit in at least one year. It appears the volatility of revenues, measured by the standard deviation of the revenue growth rate, is almost identical in the two groups. Moreover, the two groups did not differ with respect to revenue level per capita nor average growth rate. Revenue shocks seem to be of little importance for violation of the balanced-budget law, and although expenditure shocks are not analyzed, it is not unreasonable to conclude that creative budgeting in the form of overestimated revenues and/ or underestimated expenditures may play a significant role.

In an econometric analysis of budget deficits, Borge (1996) shows that both economic and political determinants play a role. The effect of a short-run or transitory revenue increase is to reduce the budget deficit. Moreover, the impact of a permanent revenue increase is less than that of a transitory revenue increase. According to the estimates, the response to a transitory grant reduction is to reduce current spending by 60 % of the revenue loss and to increase the operating deficit by 40 % of the loss. On the other hand, a transitory reduction in local taxes increases the operating deficit by 80 % of the revenue loss. This difference is as expected because a change in local tax revenue is more of a surprise than a change in grants from the central government. However, the difficulty of predicting the growth of the local tax base cannot explain that the long-run effects differ. According to the estimates, a permanent reduction in local tax revenue increases the deficit by nearly 40 % of the revenue loss, compared to around 20 % for a permanent reduction in grants.

Overall the Norwegian local public sector has not experienced serious problems of deficits and debts since the second world war. The analyses referred to above indicate that the constraints built into the system are effective. The balanced budget rule is obeyed, and localities in general

finance part of their investments with current surplus. Borrowing is restricted by the fact that interest payments and installment of debt must be financed within the balanced operating budget. The formal control of budget balance and borrowing stops any adventures into spending sprees, usually in a dialogue between central and local governments and seldom with formal actions taken.

VI. Strategic behavior and Bailouts

The combination of vertical fiscal imbalance and decentralized welfare services invites strategic behavior from the local public sector. Local governments can exploit the national political concern for the access to and quality of the welfare services across the country. It is hard for the central government to avoid blame when welfare problems anywhere in the country appear in the media, even when they are under local government responsibility. At the same time, the central government has all the instruments needed to influence the economic situation in each municipality and county. If a locality neglects the welfare services to specific groups, set excessive fees or accumulates high debt, and argue that it has been forced to do so due to external economic circumstances, the central government will be under strong political pressure to bail out the fiscally troubled jurisdiction. When information about local services and costs is limited, moral hazard may result. The experiences in this respect are summarized in this section.

Bailout in this context is understood as a transfer from central government to a specific local government in response to a local economic problem resulting from local government behavior. The transfer must not follow automatically from grant design or be permanent, and a key question is whether strategic behavior from the local government is involved. It is our contention that local units do try to exploit the national concern for welfare services across the country, but that the adverse effects of strategic behavior are small in practice. There is a permanent pressure for higher spending,

but not typically combined with distorted resource allocation. The experiences are summarized under three headings – discretionary grants, categorical grants, and campaigns for extra funds.

Discretionary grants

The case for rule-based block grants is that strategic behavior is avoided and local priorities are based on local preferences and costs. Many countries have had grant reforms implementing block grants, and have worked hard to develop robust criteria in tax equalization and needs equalization schemes. There will typically be a conflict between finding exogenous and objective criteria and reaching the desired equalization goals, since many of the relevant criteria can be influenced by local governments (i.e. unemployment). It follows that both types of schemes easily imply distorted economic incentives (tax base, cost factors and social factors). The main economic disincentives in the Norwegian block-grant system are the over-compensation of small municipalities delaying necessary consolidation into larger units, and the compensation of the high costs associated with decentralized settlement pattern rewarding cost-inefficient locations.

When grant formulas are designed or discussed, local governments will actively promote criteria to their own benefits, and certainly in Norway the establishment of tax and needs equalization has created great political controversy (see Borge and Rattsø, 1998a). In this sense, rule-based block grants are ‘discretionary’ over time. Rules are developed and modified according to a national political process. While the determination of rules is controversial, we do not think that it creates strategic distorted behavior at the local level.

Even with a strong emphasis on rule-based grants, no country avoids having some discretionary grants. Since state-dependent contracts are hard to specify and implement, the central government needs some discretion to handle unexpected events such as flooding. Also discretionary

grants typically supplement the equalization schemes, since many relevant factors are hard to represent in the rule-based system. In the Norwegian case, discretionary grants are small (total of about USD 50-100 mill. per year), but very broad – they can be distributed to take into account all kinds of ‘injustices’ between municipalities and counties. Even if discretionary grants are small, they can make a difference at the margin. Since discretionary grants are so broad, they may encourage strategic behavior to get a reward.

The only study available of the allocation of discretionary grants looks at data of the 1970s (Fevolden and Sørensen, 1983). During the period investigated, investments were high to expand schooling and health care, and some municipalities experienced debt service problems. Fevolden and Sørensen find that high debt servicing costs (interest payments and installment) are rewarded by more discretionary grants. This element of debt bailout, however, involved limited amounts, and generated more detailed control from the central government (through regional commissioners). The strengthened supervision of loans seems to have removed the problem.

The allocation of discretionary grants throughout the 1990s shows extreme stability across municipalities and counties. This is surprising, given that discretionary grants should take into account exogenous shocks affecting the localities. Interviews with regional commissioners indicate that status quo bias explains the stability. Discretionary grants first and for all are understood as correction of the equalization schemes of the block grants, and these corrections are seen as permanent in the municipalities. The regional commissioners need strong arguments about new and changed economic conditions to convince the municipalities that the distribution of the discretionary grants should be modified from year to year. Any change from status quo will generate protest from the losers. Status quo seems hard to change, even when the status quo allocation is a result of historical circumstances and is hard to argue today. In this environment, strategic behavior is excluded.

Categorical grants

The central government uses various categorical grants, often of the matching type, to promote new services. Recent examples include matching grants to new environmental projects in the transport sector in the counties and matching grants to extensions of care for the elderly in the municipalities. Such grants are typically part of a 'policy package' where the central government combines different initiatives to strengthen a priority welfare service. Such new funds for the local public sector are add-ons and not regular parts of the grant system. Ad hoc policy packages give much more political attention than modifications of a complex grant system. Since these policy initiatives are developed quite independently within the national political system, they do not create incentives for strategic behavior from individual municipalities or counties. But they represent an incentive problem at a larger scale that is of interest.

The strategic consequence of policy packages promoting new services is that localities should stick to 'optimal backwardness'. Counties that were in the front of implementing environmental projects in transportation suddenly experienced that they were punished when only new environmental projects could achieve central government funding. The effect of the new funds for environmental projects was that established environmental projects were closed down, so that all projects could be presented as new. Interestingly, environmental projects were delayed because of the introduction of new matching categorical grants to promote them. Municipalities in the front of developing care for the elderly recently made the same experience. New matching grants were introduced for the expansion of the local capacity in care for the elderly. Again localities that already had created this capacity had to use own funds, while localities lagging behind could have central government co-financing to expand their supply. When new categorical grants in care for the elderly

were discussed and introduced, local governments stopped their construction of new homes for the elderly. Political initiatives at the national level can thus create perverse local effects.

The worst example of strategic behavior in Norway is related to the financing of hospitals. Hospitals are few and visible and represent about half of the budget of the counties. Needless to say, health care is a major issue in national politics and is subject to serious problems of information and control. The central government recently strengthened their commitment to local performance in health care by establishing legal rights to medical treatment and by establishing waiting lists. Hospitals and counties have taken benefit of the central government commitment. The introduction of the block-grant system that was meant to strengthen the discretion of the counties, has worsened the incentive problems. The grant reform aimed at breaking the link between county spending decisions and level of grants, so that the counties faced the full costs of their priorities. In this context, however, the grant reform enabled the counties to exploit the national commitment to hospital services. Central government through the ministry of health care was easily mobilized for support when counties shifted funds out of hospitals and waiting lists extended.

Carlsen (1995) presents a detailed account of the strategic behavior of one large 'regional' hospital in one of the counties. The county studied was particularly active and engaged in new non-hospital activities to exhaust the financial capacity and stimulate supplementary funds. Central government repeatedly appropriated extra grants, but also introduced several new measures of control. The battle has not yet ended, and presently the county is bargaining with central government for the financing of a new hospital. This example seems to fit the 'too big to fail' argument of Wildasin (1997). Disruptions at a regional hospital have large consequences and cannot be neglected by the central government. But the central government is aware of the problem, and the financing of hospitals has been revised. They are now financed by a combination of county block grant and

matching grants related to the production of hospital services. At the same time, the ministry has improved control systems and arranged information processes to compare the performance of hospitals.

The existence of 'policy packages' and supplementary grants to hospitals must be understood on the background of the national political system. The minister of health care certainly looks strong and active when she intervenes to 'solve a problem' at a local hospital. National politicians taking the initiative to fund improvements in care for the elderly and environmental projects also may gain politically. The delegation of the spending power to the local public sector in these areas seems not to stop them from taking this political advantage. They will typically argue that local governments have not been able to handle a serious welfare issue and therefore need help from the center. In general reforms and innovations often seem to be imposed from the top. The centralized system takes the initiative away from the locals, quite opposite from the 'laboratory federalism' outlined by Oates (1999).

Campaigns for extra funds

The larger cities, and in particular Oslo, run more or less a permanent campaign for additional funds. They are active in the media and in political lobbying, and hire researchers to come up with arguments for their case. The general background here is that most European countries have problems arranging the local government structure in the capital and that the larger cities have special problems different from the rest. Since they are different, their spending needs are hard to represent in the national equalization scheme. Social problems and immigrants tend to concentrate in the larger cities, and many users of the infrastructure live in neighboring municipalities. Given that the large cities are few, it is hard to separate out what part of their spending is involuntary cost disadvantages to be

compensated and what is cost inefficiency. Since there are many central government transactions and projects of relevance for the capital, it is also hard to evaluate whether their campaign is successful. Oslo certainly has high per capita revenue level and high spending in most service areas, but the service level generally is not considered above others. While strategic behavior with distorted spending probably is not part of the game, the permanent campaign may have very bad effect on the internal fiscal discipline within the larger cities.

A few other individual municipalities have made strong attempts at getting extra funds from the central government. They are also different, but at the other end of the scale. They are all very well known in the public debate in Norway. In the mid-1980s, the 'Lurøy action' hit the media. Lurøy is a very small municipality on the north coast with a large share of the population on islands. In this periphery the population size is in decline and the age structure is increasingly shifting towards the old. The mayor and the chief administrator presented their case for extra funds to the municipality in public, claiming a difficult economic situation and bad services. Their documentation was well tailored to media attention. Unfortunately for Lurøy, many other municipalities quickly presented their case. Lurøy no longer looked different from the rest of the periphery, and municipalities closer to urban areas could document worse service levels. In the end, not much was achieved for Lurøy.

Lebesby represents a more successful case for additional funds. This is another small municipality on the coast, up at the north end of the country. Fishery is the main industry, and the municipality has guaranteed loans for a number of local companies in fishing. When fishing failed, many of the companies went bankrupt and the guarantees required large amounts from the municipal funds. The municipality could not finance the existing services, and the central government was called upon. Central government provided additional funds, but also basically administered the municipality

for a period. The conditions were sufficiently strict to discourage other municipalities affected by the failed fishing to claim similar treatment.

Single municipalities now and then appear in the media with demands for special treatment. An interesting recent case is Grue, then the home municipality of the minister of local government. Unsurprisingly, the mayor represented the main opposition party of the government. When the national budget including the grant system was discussed in the fall 1998, Grue presented themselves with plans for large cuts in employment and demand for extra funds. The largest newspaper in Norway immediately sent a team to Grue to cover their case. Different from the regular 'crisis' descriptions in the media, the journalists turned against the political and administrative leadership of the municipality and questioned the basis for their demands. The leadership was presented as 'cheating with numbers' from the local accounts. The unfortunate media attention made this case easy to handle for the central government. Typically such municipalities are convinced by regional commissioners and representatives from the ministry that their case is not that special.

The campaigns introduced by individual municipalities have had limited success, maybe except for the capital Oslo. In general the municipalities are 'too small to worry' as opposed to 'too big to fail'. Since the many small municipalities have similar problems, the central government cannot accommodate their demands. Only when clear exogenous shocks have occurred, the central government has been willing to give supplementary grants, and only when strict conditions are set that are not encouraging many others to try to follow.

Overall evaluation

While centralized financing and welfare services invite strategic behavior, our evaluation implies that moral hazard and bailout are not serious problems in the Norwegian system. For the

individual municipality and county, the budget constraint is hard. First, it is difficult for any municipality or county to 'break out of the pack'. Central government and the local public sector itself are well informed about the economic conditions and the service performance of each and all local units. When they appeal to the central government for help to handle a local crisis, the central government will know whether the locality has faced an exogenous shock or the problems are a result of own behavior. Competing municipalities and counties will keep an eye on the situation, and rewarding bad behavior will not go unnoticed. Second, strategic behavior is risky in relation to the local political process. A political leadership that creates a local crisis to get bailout by central government and is not successful will have a hard time explaining their actions to the voters. Open information about local government behavior and performance and an open local political systems seem to us essential to secure hard budget constraints under centralized financing.

VII. Reform

When local governments are an integral part of the welfare state, they are subject to extensive centralized regulation and financial control. A major objective is to provide uniform welfare state services prescribed by the central government. At the same time, local governments are formed in a long-standing tradition of local democracy and self-rule. This attempt at combining local accountability and national distributional goals implies a different type of institution as compared to the standard fiscal federalist model.

Decentralization is assumed to promote both local democracy and economic efficiency, but efficiency is not the major criterion for the present design of local government institutions. The welfare state gives top priority to the provision of essential services to all parts of the population, geographically and socially. Allocative efficiency is less emphasized in this system, since the provision

of the services is seen as a basic welfare issue. Cost efficiency is difficult to evaluate, since service quality is closely linked to costs, as with number of nurses overseeing a group of elderly. Both decision making and performance criteria are affected by the integration in the welfare state.

Rattsø and Sørensen (1998) summarize studies evaluating the performance of this system. They conclude that the welfare state model gives little scope for local democracy. The electorate is segmented into groups with different interests in welfare services, and they seem to be more active as special-interest consumers than as politically interested citizens. The party system is not well positioned to represent clear-cut alternatives in this situation. The decision-making problems impact on the local economic performance. The shared responsibility of the welfare services with the central government distorts incentives for efficiency. Public sector efficiency is hard to achieve anyway, in particular when service quality is closely linked to costs and monitoring is difficult. Inter-jurisdictional competition has been limited by low mobility, and local governments have refrained from market orientation partly due to well-organized producer interests. The complicated decision making system, the combination of local democracy and role as agency for the central government, influences the ability to hold costs down and restructure the services to changing demand. In the public debate, local governments are typically seen as rigid and with weak cost controls. Moral hazard problems are more likely within local governments, where strong internal and external interest groups can take advantage of a weak political system.

The welfare services produced seem to be costly by international standards. Comparisons are hard to make, but indicators like spending per pupil and per patient treated are high. Partly the high costs result from the desired equalization combined with a decentralized settlement pattern along fjords and up mountain valleys. Partly high costs are associated with the welfare state service monopoly with little competition and privatization. The supply side of the services looks more

influential than the demand side. The broad challenge to the welfare state is to introduce competition, consumer choice and privatization.

The centralized federalist system is characterized by frustration at both the local and the central level. The national politicians get all the blame for the welfare problems across the country, even when local governments are responsible for the spending. Local politicians gladly pass on the responsibility with the argument that the funding is determined at the center. On the other hand, national politicians can benefit from initiatives to additional spending and projects in the local public sector. And local politicians are frustrated by the limited room to maneuver and a local democracy with little content. In some sense this system of unclear responsibilities is favorable from the politicians' point of view; both politicians at the local and the central level can avoid responsibility for public services. In the long run, however, it creates the impression of "fuzzy institutions" and thereby threatens the legitimacy of the system.

Strong demands for reform in local government finance are expressed in the public debate, but there is no universal agreement on where to go. Further centralization is argued to give full responsibility of the services at the center and to get full control of the money. At the extreme, all revenues are distributed as grants and ministries are given power to regulate the supply of welfare services in each locality. It is seen as unacceptable that children shall have different quality and quantity of schooling across the country or that the health care treatment shall depend on the financial situation and priorities of each local government. Further decentralization is another way of reducing the problems of unclear responsibilities. Decentralization also will increase local accountability and strengthen local democracy and local self-rule. A government commission has proposed a set of reforms, mainly in the direction of more decentralization (see Borge and Rattsø, 1998a). The main proposal involves local tax discretion for all municipalities in setting a broad property tax. As always,

taxes seen as productive from an economic viewpoint are seldom popular. The reform process may stop because of the unpopularity of the property tax. The deeper issue is the handling of the welfare services, which will determine the role of the local public sector in the future. Competition and choice will change the financing and control of the welfare services. Then maybe local governments can concentrate on local public goods and operate closer to prescriptions in standard fiscal federalism theory.

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Table 1: Fact sheet: Norway

Approximate numbers, 1998

Population size: 4.5 million

Gross national product per capita: USD 20.000

Local public sector spending share of GDP: 18 %

Local public sector spending share of public sector total spending: 36 %

Local public sector share of public sector service spending: 65 %

Local public sector revenues: Local taxes, 46%; grants, 40%; user charges, 12%

Local taxes, composition: Personal income tax, 90%; wealth tax, 7%; property tax, 3%

Local public sector investment: 10% of current local public sector revenues

Local public sector net debt: 30 % of current local public sector revenues

Number of municipalities: 435

Number of counties: 19